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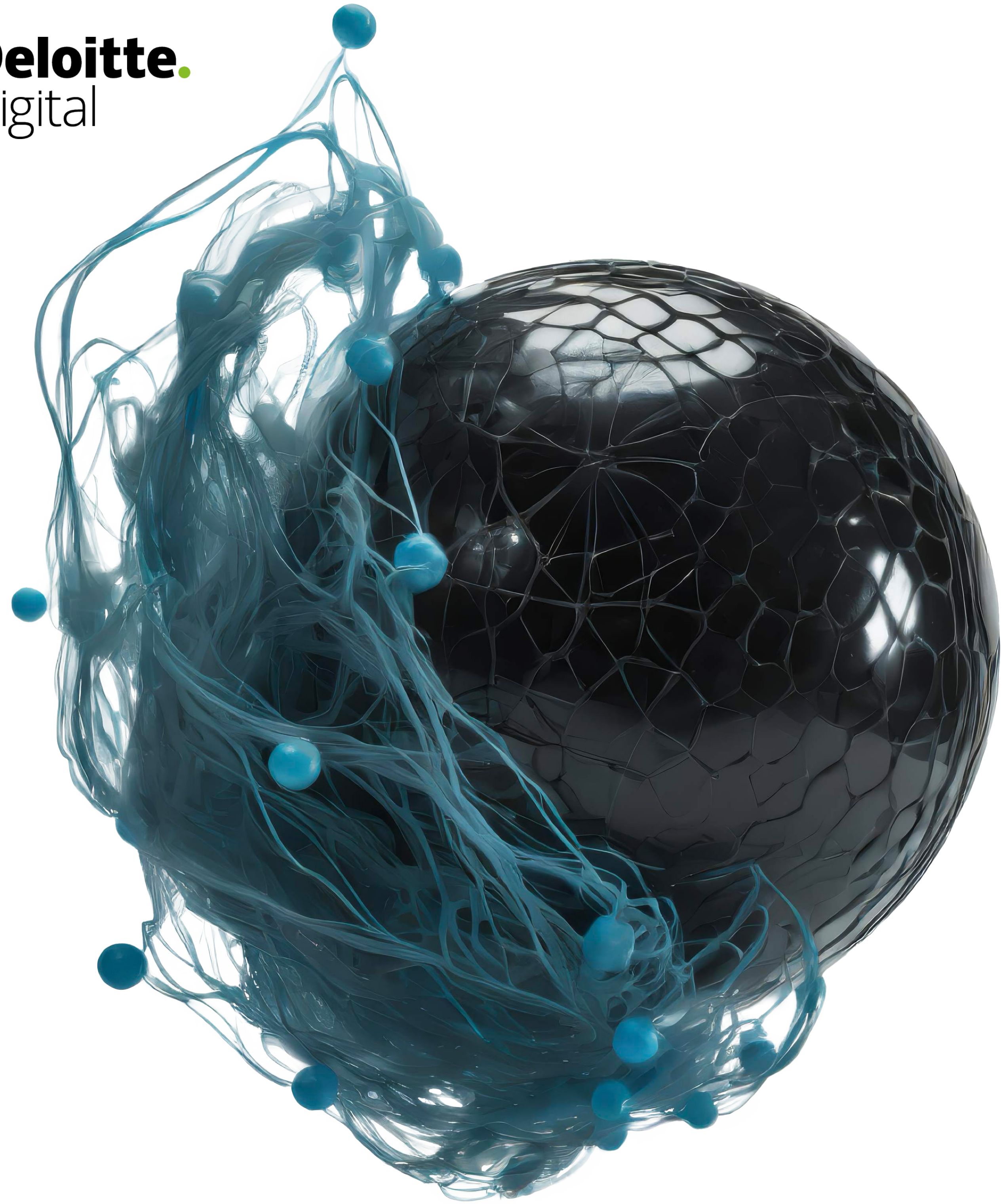


Winning in the era of digital banking

Six strategic imperatives for building successful offerings

A **global** movement

The digital banking landscape has fundamentally changed. Heightened customer expectations, growing digital adoption, and a new breed of competitors are disrupting the status quo of banking. Abundant opportunity exists for those able to position correctly and invest strategically in this quickly evolving landscape.

KEY GLOBAL HIGHLIGHTS INCLUDE:

4.2B

People who will use digital banking services by 2026[1]

$98B

Global digital banking deposits as of 2023[2]

17

Challenger banks valued as unicorns globally; eight are in the US[3]

>95%

Of digital challenger banks globally are not profitable[4]

Banking services are no longer being provided by banks alone.
New non-bank entrants and digital challenger banks are elevating their banking offerings with differentiated propositions and customer experiences. Enhanced competition will result in many players being left behind.

The competitive landscape has expanded beyond traditional financial services providers and now comprises a variety of banking and non-banking providers.

COMPETITORS INCLUDE…

Incumbent banks

Traditional banks implementing digital-forward solutions and leveraging existing brand influence to drive business.

FinTech organizations

Businesses leveraging technology to provide specialized financial services solutions, targeting a specific part of the value chain.

Digital challenger banks

Banks built on digital-native platforms and operating exclusively through digital channels.

Non-banks

Traditionally non-financial organizations that leverage their technology, assets, and brand to diversify into banking products and services.

In the United States, opportunity remains for a digital champion to emerge.

Reach of digital-only banks

27% Of Americans currently bank with a digital-only bank *(i.e., digital challenger bank)*[5]

Changing customer expectations

35% Of customers increased online banking usage due to COVID-19[6]

Growth of FinTech maturity

20.3% Approx. CAGR increase in global FinTech market 2020-2030 *(to $698B)*[7]

Satisfying customer needs

79% Of customers are willing to switch banks to one that better meets their needs[8]

New digital entrants and FinTech organizations are making increasingly bold plays while incumbents seek to protect market share with digital transformations and big brand non-banks seek to disrupt the status quo.

Through our extensive work in the field with incumbents and new digital entrants, **we have observed what it takes** to build and scale successful digital banking offerings.

In this report, we will highlight the **six strategic imperatives** that businesses need to get right when developing market-leading digital banking offerings.

Six strategic imperatives

for building successful digital banking offerings

The players who best optimize across the following imperatives are more likely to realize long term success:

1. Customer strategy and segmentation

Focusing on target segment needs to **drive trust and inclusion,** while keeping an eye on mass market appeal

2. Brand, experience, and proposition

Building a personalized proposition that is **digitized for the right moments**

3. Business model

Making the right strategic decisions to **remain economically viable, and not just desirable**

4. Operating model and organization design

Enabling a **nimble organization** aligned to delivering and scaling the digital proposition

5. Risk and compliance strategy

Strategizing for the breadth of **regulatory transformation triggers**

6. Technology, infrastructure, and platforms

Prioritizing a technology stack to **drive differentiated propositions and improved performance,** while balancing cost and scalability

1. Customer strategy and segmentation

A hyperfocus on your target segment needs to drive trust and inclusion, while keeping an eye on mass market appeal

Winning players focus on designing propositions that address unmet needs of target segments, while keeping an eye on mass markets to ensure their propositions have a pathway to broader opportunities. Empathy and trust are x-factors to drive customer stickiness.

Changing the way we segment

New digital banks are entering the market at unprecedented rates and are re-designing segmentation principles

With 61% of customers willing to switch to a digital bank,[9] aligning experiences and propositions towards the needs of target segments is essential to accelerate acquisition, encourage switching, and differentiate.

Innovative players are investing in data-driven market segmentation, leveraging insights, and analytics capabilities to deeply understand and test unmet needs of niche segments.

Winning with empathy and needs-centricity

Winning digital banks establish deep relationships with customers by affiliating with their values and communities. Segmentation goes beyond wealth brackets or geography, but includes values such as empathy, inclusion, or a stand on ESG. Customers can reflect their values by interacting with brands that have proven an understanding of their community's needs.

Unleashing segment potential with tailored offerings, innovation, and pricing

Segmentation is now a discipline applied beyond the marketing function—it is leveraged by products and innovation teams to deliver tailored products and services that address unmet needs aligned with customer values. Digital disruptors are attracting loyal customers to maintain and expand their market shares by offering human-centered experiences and tailored pricing.

Keeping an eye on mass market appeal

While focusing on a key segment is important to differentiate, creating a pathway to a broader market appeal expands revenue potential.

Launching multi segment brands

Digital disruptors need to be mindful of the non-scale economics and slower customer acquisition that might exist with a hyper-targeted customer strategy. Extending product offerings (particularly to high margin products) and targeting various niche segments simultaneously through multiple brand propositions can help to offset concentration risk and accelerate growth of the customer base.

Harnessing data to effectively uncover needs

Open finance is the trend, but open data is the differentiator. Limited data access can be a deal breaker for a brand trying to win over a niche segment.

Leveraging data capabilities to effectively segment

Data sharing is the foundation of open finance practices and creates an opportunity for accurate and meaningful segmentation. By sharing and leveraging customer insights across secured platforms, especially beyond banking ecosystems, offerings can better address unmet customer needs. Digital banks sharing open data securely will differentiate through tailored experiences and products identified from the enhanced data. For example:

- By leveraging data and insights of niche segments driven from connectivity across healthcare platforms, digital disruptors can provide payment solutions for an existing health hardship and insights on how to best recover from a high payment event
- By leveraging insights from hospitality platforms, digital disruptors can suggest and help finance integrated travel experiences

Creating digital moments that matter

When designing a digital journey, it is crucial to understand when customers crave digitization and when they prefer human connection. For example, 29% of millennials are likely to open a deposit account digitally, while 33% prefer branches for financial advice.[10] Consumers desire high-touch interactions for complex products and services, such as mortgages and financial advice, and they tend to prefer digital channels for lower-complexity tasks.

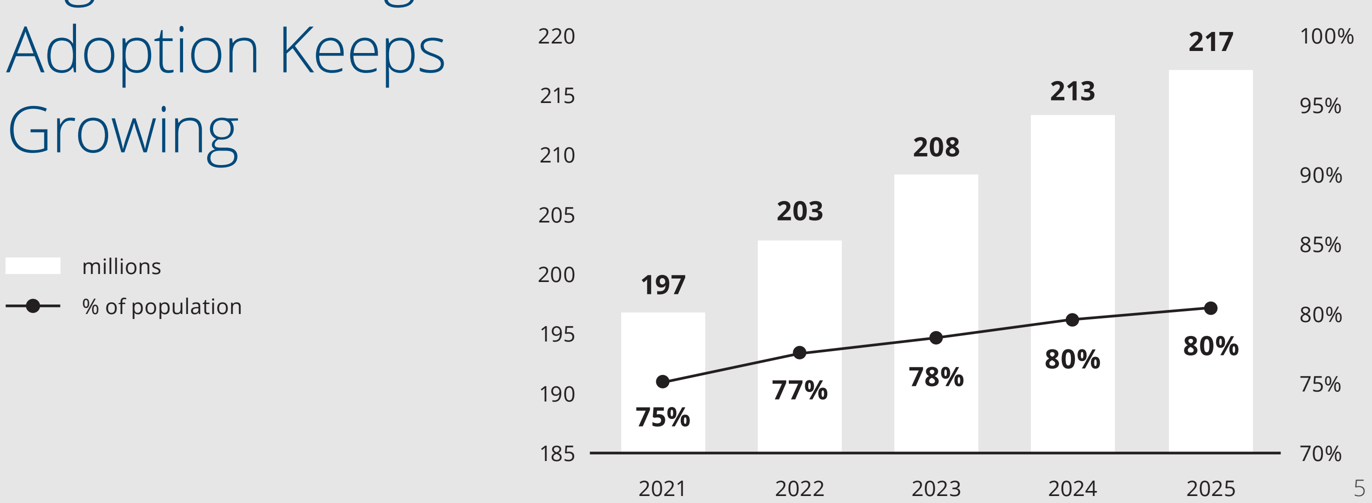
Customer segments also express different needs. For example, 30% of millennials versus 8% of baby boomers prefer digital channels for financial advice.[10]

All to enforce stronger relationships and drive a deeper relationship

Digital-only banks have proven successful in capturing customer attention and in turn generating rapid customer acquisition rates, but no one player has taken a consistent lead in maintaining customer engagement —meaning new digital entrants need to meet customer needs at a deeper level to become their primary or exclusive financial service provider.

Digital Banking Adoption Keeps Growing

US Digital Banking Users and Penetration[12]



Establishing digital trust and inclusion

Recent market events have damaged customer trust in financial services

In particular, digital-only banks face a significant hurdle in establishing trust, as customers are less likely to perceive them as reliable compared to traditional incumbents who have maintained market share and brand awareness longer.

Cultivating trust as a strategic imperative to boost loyalty and stickiness

Digital disruptors can elevate trust by focusing on four factors that we developed through our TrustID™ program: Humanity,[A] Transparency,[B] Capability,[C] and Reliability.[D] The numbers don't lie: trustworthy disruptors outperform their peers by 2.5X, 88% of customers who highly trust a brand re-engaged with that brand, and 79% of their employees feel motivated to work and deliver a loveable experience to customers.[11]

A Humanity – Brand demonstrates empathy and kindness and treats everyone fairly

B Transparency – Brand openly shares all information, motives, and choices in straightforward and plain language

C Capability – Brand creates quality products, services, and/or experiences

D Reliability – Brand consistently delivers on promises and experiences

61%

willing to switch to a digital-only bank[9]

Across industries, financial services scored lowest for prospects with the weakest scores in Humanity and Transparency. Digital disruptors can differentiate from a Humanity and Transparency perspective by designing inclusive experiences and establishing a clear intent within its brand messaging; this focus has proven in some cases to cause customers to be 5.5x more likely to positive rate a brand.[11]

Making sustainable business decisions

Making sustainable business decisions and incorporating ESG principles into operations can help banks attract a growing customer base and build stronger relationships with individuals who value community-centric brands. Customers increasingly prioritize values-based banking and expect banks to align with their sustainability goals.

2. Brand, experience, and proposition

Building a personalized and differentiated proposition

Demands and expectations around digital banking products and propositions continue to grow as customers seek highly digitized, seamless, and increasingly engaging experiences.

Making digital-first design decisions

Digital disruptors go beyond digitalizing the banking process—they win through curated personalized experiences

With over half of the global population predicted to use digital banking services by 2026,[1] enabling digital banking experiences is table stakes.

With 26% of bank CIOs defining digitalization as their first priority,[13] banking experiences such as onboarding, account services, product switching, and account closure are predicted to be digitally enabled as industry standard next 3-5 years.

Personalization will be the driver for differentiation. True differentiation through personalization will not require web cookies and will be based on proprietary insights on the human experience (e.g., omni-channel service experiences, personalized onboarding, saving insights).

Simplifying where necessary, differentiating where valuable

As digital disruptors need to shift from hypergrowth to profitable growth, operational efficiency will be essential to win. Less complex activities with low revenue potential or customer impact can be fully digitalized (e.g., account status, onboarding) to reduce costs; whereas high-value interactions such as financial advice or service must be hybrids of digital and human channels. Digital disruptors can provide channel choices to higher-value customers and focus on digital channels for lower-margin segments to further improve profitability.

Humanizing high value experiences

Digital disruptors need to elevate moments that matter to win and maintain customers. For example, one winning digital bank today is enabling parents to add their children to their accounts to encourage purpose-driven savings and to support financial education. This expands brand value into beneficiaries. By leveraging transactional data, the disruptor engages with customers through insights on how to save, spend, and invest to better achieve financial goals.

Gamifying, incentivizing, and rewarding to drive engagement

Connecting at the emotional level is now key

New digital entrants are embedding gamification tactics in their user experience. Gamification approaches help customers enjoy their banking experiences more. Examples include using fun features such as progress bars, goal setting, and push notifications to make banking more of an activity rather than a chore or transactional task.

Through gamification, digital entrants create more opportunities to reward and incentivize customers for their spending behaviors—ultimately triggering more engagement.

Gamification isn't the only trend for personalization, but it has proven successful. Although not typical in all players yet, those who have applied gamification strategies have found customers to be more engaged and more likely to continue to use services—showing increased customer retention and conversion rates by up to 700%.[14] Data collected through gamification can also help organizations understand the best way to attract new customers and how to best service existing customers by more effectively understanding their needs.

Incentivizing with the right tactics to increase engagement

Gamification, incentives, and reward tactics vary by the design objectives of the bank and their target proposition, but most focus on incentivizing continued customer engagement (whether from a cross-sell or feature perspective.) Some proven examples include:

- Incentivize customers to watch educational financial videos and bank through point systems where users can win prizes including music, movie tickets, and sporting event tickets
- Badges and leadership boards provide visual tools to recognize users' achievements, encouraging progression and continual engagement

A trustworthy brand & product proposition drives human behaviors and business outcomes

88% of customers who highly trust a brand have bought again from that brand[11]

62% of customers who report highly trusting a brand buy almost exclusively from that brand[11]

- Customer tiers show progress and achievement, allowing for visualization of journey status and motivation to spend to move up levels
- Offering rewards for specific behavioral patterns (e.g., spending local, meeting saving goals, etc.)

26%

of bank CIOs defining digitalization as their first priority[13]

Banking experiences such as onboarding, account services, product switching, and account closure are predicted to be digitally enabled as industry standard next 3-5 years

Design, launch, and test propositions to scale quickly

Applying human-centered, agile, and inclusive product and experience design approaches to launch valuable propositions

Focus on rapid launch, with humans at the center of everything

The ability to launch new propositions quickly, listen to customer feedback, pivot, and scale will be essential to lead and win the digital banking race. Winning digital disruptors apply a customer-centric lens through the entire product and experience design lifecycle, spanning research, design, prototyping, initial launch, and scaling. Winners will move quickly in agile sprints by leveraging best in class product management practices. As customers increasingly prioritize brands that match their values, disruptive brands seek to surface inclusive offerings, experiences, and messaging while internally enhancing the way they work, research, and make business decisions.

3. Business model

Achieving balanced growth

Driving growth and achieving profitability with digital-only propositions is challenging and—to date—few have gotten it right.

Customer acquisition is just the first step

Robust customer acquisition does not necessarily equate to profitable growth

Despite recent market challenges, deposits held at digital challenger banks have been consistently growing and are on track for 78% growth between 2022-2028.[2]

While some new digital entrants have been successful in attracting and acquiring customers, only 15-20% of new digital entrants' customer bases are considered 'active' (as measured by monthly interactions)[15] and revenue per customer is typically low (rarely exceeding single digit or low double digit annual revenue per customer.[4])

Many new digital entrants are therefore struggling to incentivize increased engagement through initiatives like loyalty rewards programs. This approach can include rewards such as one-time credits for direct deposit enrollment and channeling customers into more profitable products and services such as interest income-focused products.

The funding market is now demanding a path to profitability

Whether doubling down on one part of the value chain or targeting the development of full-service offerings, different viable business model options are available with associated success stories.

However, having a clearly defined path for the chosen business model is essential, with a need to balance growth and investment in the business against the path to profitability.

In particular, the funding market is increasingly focused on this path to profitability. The pressure is on those entrants who are unable to successfully convert rapid customer growth to profitability quickly enough or are unable to convince the market of their overall vision and roadmap to drive the business to a sustainable (and profitable) position.

Focus on propositions that encourage activity

Securing and increasing "share of wallet" is highly competitive. New digital entrants need to be creative in developing and executing their monetization strategies by offering the right incentives to attract customers. Most crucially, they need to keep them active and engaged to acquire a meaningful share of wallet.

Success comes down to the ability to roll out timely products and services that resonate, encourage engagement, and leave customers feeling their needs are being addressed with added value to their banking experience.

A targeted product roadmap is essential to drive growth

Successful new digital entrants are increasingly focused on achieving success with specific customer or product segments. They carefully choose the right moments to expand their offerings.

Targeted launch offerings with rapid expansion

A common practice is to strategically sequence products through Minimal Viable Product (MVP) releases and embed digital-first features at the point-of-need. As a result, targeted launch offerings with a rapid expansion to adjacent products & segments is critical to enable growth. A few examples include:

- **Deposit-led players:** Many new digital entrants start their product roadmap with vanilla deposit products. This drives quick customer growth if coupled with strong incentives but introduces difficulty in driving longer term profitability and risks over-reliance on fee income and favorable interest rate environments
- **Lending-led strategy:** Success stories typically focus on capturing a niche lending segment and later expanding portfolios to drive increased share of wallet and market penetration. Of course, over-reliance on lending exposes credit, interest, and other related risks, which are particularly relevant in the current market environment. However, this approach has enabled some new digital entrants to become some of the few profitable digital banks in the U.S.
- **Brand establishment approach:** Non-banks can have the upper hand in differentiating and capturing a unique cut of the market by leveraging existing brand equity and, in some cases. ready-made distribution channels. Their existing deep customer insights enable rapid capture of market share by quickly deploying offerings they know will resonate with their customer base. In parallel, the cost to acquire is reduced due to the pre-existing loyalty and insights across the existing customer base

The return of high-yield rates to incentivize digital adoption

To drive digital adoption, customers need to be rewarded with tangible benefits such as better rates and lower costs. There is a resurgence of high-yield interest rates (5%+) where customers are incentivized to move their money into digital banking platforms.

A lending, deposit, or mixed approach, along with the sequencing of the rollout, is a critical decision with inevitable trade-offs along the journey. The core of the business model must be a highly developed customer strategy and a deep understanding of customer needs must guide the work.

Globally, around **5%** of Digital Challenger Banks are profitable[4]

There are a few **key components** that directly influence the revenue that can be generated from a digital propositiion

Customers

Growing an engaged customer base by cross-selling personalized offerings to drive sticky, meaningful relationships

Move to interest income

A rapid push to interest income products will improve the likelihood of near-term profitability, however, the capital, liquidity and operational requirements to lend proce an early barrier for many

Beyond Banking

Customers are demanding their banks provide a broader range of services, providing an opportunity to diversify reveue streams and increase share of wallet

Diversify to drive sustainability and profitability

Diversification not only expands revenue pools, but is also helpful to stabilize the business and offset risk exposure

Tailored offerings paired with targeted acquisition and engagement strategies are an important means of establishing a strong initial customer base. However, once established, a crowded competitive landscape with typically low switching costs means that new digital entrants must quickly think about diversification to secure their customer base, drive loyalty, and encourage ongoing engagement. Diversification strategies must be carefully considered against strategic priorities. Typical examples we see in the market include:

Product diversification: Diversifying a target segment's available product portfolio, such as including investment products, can help capture a broader financial relationship. This method increases customer stickiness and revenue potential, but could place a limit on the addressable market and increase the elements of concentration risk.

Segment diversification: Expanding product and service offerings to resonate with a broader set of segments (e.g., diversifying loan portfolio beyond retail to include SMB,) can increase the addressable market. However, we are increasingly seeing competitors (particularly non-bank entities) positioning themselves to serve multiple clients' needs simultaneously. A broader segment offering at the expense of product and services depth can reduce the likelihood of being adopted by customers as their primary relationship provider, and thus limit loyalty over the longer term.

Non-financial products and services: Developing offerings that go beyond banking can result in more unique experiences that stand-out in the market (e.g., marketplace offerings, subscription services) and innovative revenue channels (e.g., white-labelling of technology products.) Going beyond traditional parameters can help to differentiate offerings and increase customer loyalty, but requires investment to implement and maintain, and adds an additional layer of complexity to the growth and operational strategy.

Faced with competition from both digitizing incumbents and non-bank competitors, new digital entrants who may have already achieved market entry and have secured a customer base should be innovative in diversifying their offering portfolio to protect market share and diversify revenue streams.

To further bridge segment and product or service expansion, these companies can look beyond traditional diversification techniques to harness potential advantages such as technology capabilities, brand equity, and customer insights to bring new, out-of-the-box products and services to the market.

4. Operating model and organization design

Digital transformation is no longer just a technology play

Making the mistake of focusing too heavily on adding near-term value to customers (e.g., new features) can be costly if the organization cannot scale or quickly react to new market demands. With the right lens, you can create a memorable 'onstage' experience while orchestrating a nimble 'backstage' structure of capabilities to meet external and internal needs seamlessly and quickly.

Championing a capability-based operating model

Capability and customer-centricity at the core

Structuring around enterprise-wide capabilities to streamline operational processes, experience design, and economies of scale has enabled some banking disrupters to maintain their pace with rapidly changing customer needs and demands.

Orienting to capabilities can help rapidly deliver relevant products and services with timely responses to the market.

Customer-Centric disruptor spotlight:

Determined to reduce dependency on a technical team for deployment of web experience improvements for a credit card application process, an entrant to the digital banking space stood-up a 'horizontal' web channel team. This team was dedicated to building an MVP tech capability that would streamline the operational processes of a customer-dedicated 'vertical' team to make new web deployments quick and easy.

Standing up teams aligned to prioritized customer experience journeys

Enterprise-wide capabilities are critical to adapt to constantly evolving demands, but it is the experience these capabilities enable that will show tangible success.

Organizations need to identify their priority customer journeys to deliver in a series of MVPs (based on the target segments of the organization) and build customer-oriented teams and capabilities around the journey design. These teams and capabilities have the primary goal of uplifting both the customer and employee experience.

There is not just one way to enable the targeted experience. Some proven approaches include:

- Cross-functional structures dedicated to a customer journey vision
- Experience Center of Excellence (CoE) as a go-to team for tools, standards, and subject matter experts that deliver a leading customer experience and design

Prioritizing low-code and no-code capabilities

A capability-based operating model does not end with enablement of experience design.

Disruptors are prioritizing next-gen platforms to enable low-code and no-code development of their capabilities. This allows for quick deployment of MVPs due to fewer integration complexities. In an era of frequent product updates, customers have come to expect new features to roll out consistently, and a manageable tech architecture of low-code and no-code capabilities is crucial to meet this demand.

As a result, players are adding new features and integrations with basic levels of development expertise and relieving themselves of the dependency on horizontal teams.

Implementing strategy-oriented roles within leadership allows players to:

- *Identify and leverage emerging technology capabilities*
- *Optimize short and long-term growth*
- *Better understand the current market to forecast the future*
- *Assess industry competition for areas of opportunity*
- *Properly revamp talent models to break organizational silos*

Rethinking talent model and organizational design

Balancing industry expertise and technology competency

As more digital-only disrupters emerge, a common theme of success is striking a balance across technology, strategy, risk, and core banking roles to meet banking requirements and technical aspirations while avoiding regulatory pitfalls.

New players often struggle with core banking functions because their initial focus is on quick speed-to-market and a differentiated experience. With an isolated focus on technology and design, compliance becomes an afterthought—leaving companies vulnerable to regulatory scrutiny.

For incumbent players, they have the upper hand in leveraging their legacy knowledge and operating models centered around core banking functions. If they can leverage this competitive edge when launching a digital bank, they can use risk and regulations as a form of checks and balances to meet compliance requirements while driving towards UX parity with disruptors.

Cultivating a forward-looking organization

Product innovation in the digital banking space has vastly accelerated in recent years to meet customer demands, including robo-advising, hyper-personalized product configurations, integrated stock and crypto investing, and more.

This can be partially attributed to disruptors investing in strategy roles beyond technology, UX, and core banking to proactively plan their product roadmaps amidst rapid market changes.

Implementing strategy-oriented roles within leadership will allow players to identify and leverage emerging technology capabilities, optimize short-and long-term growth, better understand the current market to forecast the future, assess industry competition for opportunity areas, and properly revamp talent models.

Breaking organizational silos

A leading operational structure is more than just talent. New digital entrants are tossing traditional models aside and establishing autonomous vertical organizational structures. These structures have experience-owned teams aligned to businesses and products with P&L-specific objectives. As a result, these entrants are breaking the silos of traditional models that can create inefficiencies in decision-making, deployments, and collaboration.

How can you break these silos?

- **Centralized product and ops ownership:** Single accountable owner responsible for product strategy, development, and delivery (e.g., ops) that enables a holistic customer view
- **Channels centralization:** Centralized physical and digital channel overseeing channel capabilities and operations while ensuring connectivity with member experience teams
- **Centralized servicing operations:** A dedicated servicing ops capability focused on commodity servicing while channeling specialized servicing to product teams (e.g., CRE)
- **Centralized data organization:** Centralized data leadership to drive data strategy and A&I capabilities while managing data infrastructure in partnership with engineering.

Capitalizing on low-cost operations and partnerships

Prioritizing strategic partnerships

Faced with challenges that arise from being newcomers in the industry, banking disruptors are looking externally for third-party vendors and partnerships to further bolster their capability areas while providing an opportunity to reduce costs.

One method that traditional organizations can approach this with is partnering with a platform-as-a-service FinTech organization to gain access to a complete cloud environment for building and managing scalable applications.

Additionally, smaller digital-only players have a regulatory opportunity to partner with more established, insured banks to expand their product suite, capitalize on existing brand equity, and leverage long-lived core banking expertise. However, keep in mind that partnerships of these sorts may limit autonomy in decision-making and visibility into revenue and cost streams.

Outsource areas of limited expertise

To scale and stand up as quickly as they have, some disruptors have been highly strategic about their staffing model. They hire the best talent—often aligned to tech and business strategy—to build and grow their products and services while retaining a lean, cost-effective organization.

Doubling-down on in-house strengths

Focusing on what players do best will enable them to double down on their strengths. Both traditional, on-the-edge, and digital-only banks can optimize cost savings by outsourcing—sometimes to each other—the expertise areas that each organization does not specialize in. Traditional financial institutions, for example, can offer valuable, deep experience in core banking functions, while digital challengers can provide keen insights on customer experience and digital offering best practices. These plays will be crucial to keeping pace with the constantly evolving marketplace.

Operating model design efficacy varies by the legacy operational structure of the organization, but there are **key plays that have proven successful…**

Agile Model Adoption to Avoid Siloed Ways of Working

A leading FinTech mobilized around traditional business and technical roles to reduce siloed teams - adopting agile models to support their 'born in the cloud' organization

Strategy Roles to Diversity Talent & Plan for Future Needs

An online bank hired lead roles focused on growth and customer experience - expanding talent structure beyond typical tech roles to maintain a proactive growth strategy as the market evolves

Best Practice Regulatory Function to Avoid Common Pitfalls

A digital bank prioritized committees for audit and risk & compliance from the onset of the bank's launch - mitigating the common pitfalls of digital banking risk management that result from undiversified talent

5. Risk and compliance strategy

As the digital banking marketplace expands, risk and compliance management needs to remain within strategic priorities. With heightened scrutiny, new digital entrants and incumbents must enhance their risk management infrastructure.

Understanding why there is increasing regulatory scrutiny

The coexistence and partnerships between different components of the ecosystem has increased complexity of the risk landscape

Incumbents, FinTech organizations, challengers, and non-banks alike are partnering in efforts to capitalize on efficiencies, deploy products and services to market more rapidly, and go to market offering a more seamless experience to customers.

The evolution that brought the ecosystem to heavily rely on system interoperability has resulted in more new players, particularly FinTech organizations accessing the banking system. Levels of sophistication related to risk management and security vary, and regulators are heightening scrutiny to ensure that roles, responsibilities, and accountability are clear within the banking system.

Fourth-party risk is becoming as significant as third-party risk. Fraud, financial crimes, and cyber threats are evolving, and thus creating the need for controlled environments that can keep pace.

Common pitfalls

Regulatory scrutiny is heightening due to growth in new market entrants, but also due to some of the costly mistakes by certain players.

For example:

- A millennial-focused digital bank prematurely launched card products that were non-compliant with strict EU customer authentication card regulations, which severely damaged their brand reputation as many customers were required to shred cards
- A global digital bank encountered KYC and onboarding process glitches, which allowed a customer base of millions access to open accounts with fake passports and resulted in customer mistrust
- A US bank launched a new digital-only deposit product with weak fraud and KYC processes, resulting in high-dollar fraud losses in the first month of the new product launch

Impacts across the full enterprise risk management framework

Core modernization and related product launches impact each of the risk domains

For incumbents, traditional core banking operating models provide a competitive foundation of regulatory familiarity and enterprise risk management maturity, where new digital entrants may struggle.

Incumbent risk and compliance strategy

Incumbents should leverage existing risk and regulatory compliance expertise to remain competitive, and in parallel must strengthen their foundational risk and compliance capabilities. Inherent risks across each of the applicable risk domains should be mapped to this new target state. Likelihood and impact should be rated for each risk. Conclusions should be reached regarding where existing controls can be extended, versus areas where net new controls will require design and implementation.

From a non-financial risk management perspective, incumbents must customize their risk appetite to include digital bank coverage and create new KRIs and KPIs to support expanded products. In addition, incumbents should extend and customize their existing operational, compliance, legal, strategic, and reputational risk capabilities for coverage across these new banking product(s), technology stacks, and corresponding target state business operations.

From a financial risk management perspective, incumbents must effectively manage credit, interest rate and liquidity risks that are presented based on the products being launched (e.g., advancing the credit model and underwriting guidelines and policies according to newly in scope products.)

Regardless of the product being launched, core banking modernization efforts typically leave very few risk domains and business processes untouched, and incumbent banks must align their risk management and compliance capabilities to these new target-state operating models.

New digital entrants' risk and compliance strategy

New digital entrants need to assess current and future BaaS partnerships to evaluate whether there is sufficient clarity in roles and responsibilities, decision rights, corporate governance, and management to appropriately mitigate risk.

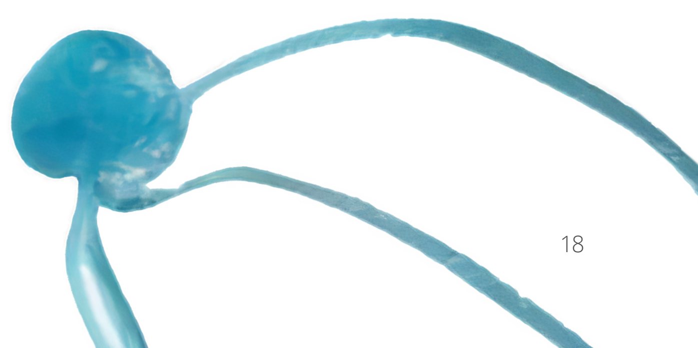
Investments in control automation, designing an effective enterprise risk management program, and understanding clearly how and where risk mitigation is built into next-gen technology stacks and ancillary processes will be critical success factors for these players.

Although prioritization of customer-centered teams and technology roles have allowed new digital entrants to achieve speed-to-market efficiencies, risk and compliance considerations cannot be a trade-off and are instead a key enabler to the business model.

As customers are becoming more willing to bank with digital-only entities, new digital entrants need to be able to operate at scale when it comes to managing risk and compliance, data security, and more to safeguard both the customer and the institution.

For digital entrants, appropriately managing risk across financial risk domains must include credit models and underwriting for products and treasury management, which can include balance sheet exposure and liquidity management.

Ultimately, managing risk across BSA/AML, KYC, operational, and compliance risk domains are critical to effectively manage one's brand, reputational risk, business performance, and customer experience.



Optimizing the control environment

The time is now to redesign the control environment

Core banking modernization efforts present an opportunity to redesign the control environment and build the business for future scaling.

Modernizing risk management controls

Many incumbent banks have experienced challenges in harnessing the benefits of controls automation. Legacy processes and mainframe technology has often rendered automation cost prohibitive, with highly-manual workarounds deployed to meet requirements.

As incumbents modernize their core banking platforms and as digital entrants approach design, both must take advantage of the opportunity to deliver a target-state that mitigates risk holistically. Bringing together control functionality native in technology solutions with robust data analytics is key to developing an efficient and compliant target-state. Risk and compliance partners should be embedded in these transformation projects from the outset. Their ability to have an early influence on target-state requirements that care for risk and regulatory obligations can deliver an operating model that is more efficient and allows the business and product owners to scale faster.

Organizations are investing in smarter technology and can leverage the benefits of AI and machine learning to develop risk and control frameworks that are highly automated and help to maintain efficiency in an increasingly complex and data-heavy banking ecosystem.

Investments in control automation, designing an effective enterprise risk management program, and understanding clearly how and where risk mitigation is built into next-gen technology stacks and ancillary processes will be critical success factors for these players.

1/2

of Americans worry about the safety of their money

Creating an opportunity for digital players to become trusted players through investments in risk management best practices[16]

6. Technology, infrastructure and platforms

Incumbents and new digital entrants alike are embedding next-gen technology into banking norms and re-inventing how they can deliver banking experiences digitally.

Embracing modernization in favor of legacy technology across the organization can serve as a building block to amplify product innovation, agility, and speed-to-market. Getting there introduces many hurdles and choices along the way.

Enterprise technology strategy first

Adopting the right approach to meet the right objectives

Embarking on technology modernization can deliver profound benefits across the organization. Today, organizations can shepherd in a new era filled with opportunities to enable growth and drive operational efficiency.

In our experiences, organizations which have successfully broken ground with momentum have taken tactful approaches to gaining early alignment across the organization. Fundamental areas include the value to the business, end-state platform vision, spend appetite, and architecture principles.

A careful and strategic approach can help avoid costly pitfalls like re-worked approaches, slow moving business cases, or sub-par architecture with a propensity for higher technical debt.

Overcoming these obstacles will require elevating the conversation beyond the criticalities of the technology benefits to deliver a more holistic vision that creates value for all stakeholders involved. Our clients who invest the time into collaborating on that vision are gaining higher alignment during execution and are maximizing their benefits realization through more integrated outcomes.

Defining enterprise goals first

Banks should first define their enterprise goals and identify organizational drivers to inform the right technology transformation path.

Having a defined set of enterprise criteria—on which business and technology teams collaborate—can create the foundations and guardrails to drive how a bank gets started and where they will materially position.

Examples of common questions we have observed in market that should be addressed up front include:

- What technology capabilities require the most modernization and why?
- How do we see our technology talent evolving over time?
- Where will the benefits be derived from? Revenue, cost savings, or both?

- How aggressively are we willing to modernize?
- How much engineering effort are we willing to bite off?
- What architectural principles are fundamental to work towards?

Assessing tech transformation options

There are various technical approaches to consider that lay the foundation for revenue potential and cost-side derived from digital banking initiatives. Each has different implications and materially impacts the effort, length of time, risk, and timing of value delivery.

Increased reusability

Players note the ability to leverage 2/3 of their industry cloud solution for a similar effort in another market, accelerating the time to market.[17]

Getting the core right

Defining the path toward highly-efficient core systems to realize benefits quickly

Players are increasingly acknowledging the need for a modern core and recognizing the benefits aligned with new digital opportunities. However, banks must first decide how to move forward and implement a new core to achieve desired business outcomes.

Benefits of modern core systems adoption

Players that can capitalize on these new digital opportunities may enjoy huge benefits in customer share and profitability, internal skillsets, agility, and product innovation—all boosting their competitive advantage through differentiation and real-time capabilities. Additionally, highly-efficient and scalable core systems have the potential to bolster growth and transform operating costs.

Strategies for quick value realization

Depending on organizational needs, tailored strategies to realize value can be done separately or in parallel. The paths below enable players to start small, while realizing value quickly and supporting scalable growth:

- **Client proposition-led:** Thin, core-enabled greenfield architecture to launch a new product proposition into the market to compete and differentiate. It is unhinged from the legacy core
- **Business capability-led:** Hollows out the core for select modern capabilities to deliver broad value to the enterprise quickly
- **Technology foundations-led:** Builds modern and cloud-native technology foundations to deliver highly scalable orchestration, real-time data, and advanced analytics

Choosing the most favorable approach

Implementing a new core requires designing a targeted solution. Whether pursuing a traditional migration, dual-core coexistence, or an on-the-edge transformation, the strategy should enable efficient modernization for front- and back-office experiences and solve challenges with systems integration and infrastructure.

Moreover, it’s important to consider the operational, business, and culture implications within the bank. These areas can often be overlooked—especially during the vendor selection process—and have the propensity to create friction during design and implementation.

Building a modern architecture

Making decisions in an endless menu of technology options

Players are ramping up on the buy-side of the buy versus build model and strategically partnering with FinTech organizations offering targeted solutions to outsource much of the innovation needed to compete in today's marketplace.

At the same time, many of our clients have made strategic investments to build custom solutions in the areas they see most critical to delivering their differentiation in the market. However, those investments have not reached optimal value due to an aging core that has become a nuisance to achieving the level of innovation now occurring with FinTech organizations starting with blank canvases—unhinged from decades of legacy technology infrastructure.

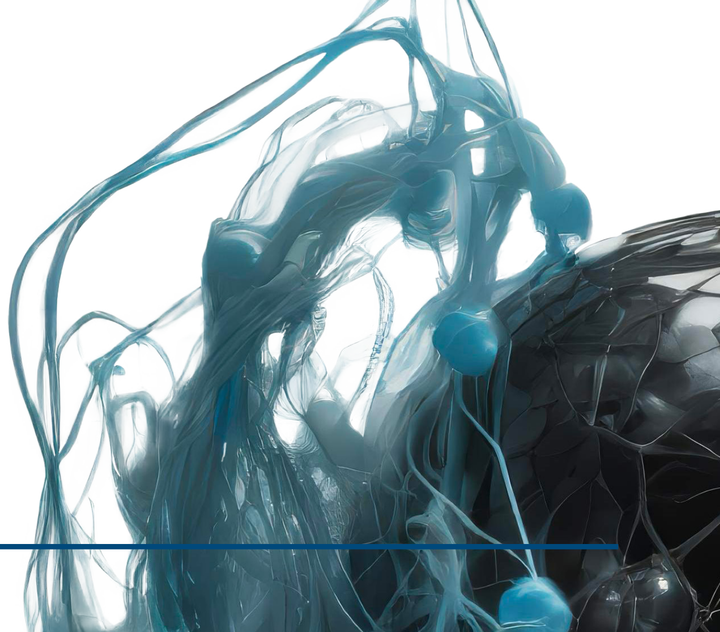
The number of vendors offering solutions is vastly higher than just a few years ago. The sheer amount of choice can overshadow some of the more fundamental decisions that companies need to consider when starting out.

Where to begin?

As clients begin to look towards their next big push for technology modernization, a comprehensive review of the technology stack across their engagement layer, orchestration, banking capabilities, data, and infrastructure is a foundational first step to determining the optimal blueprint for their future.

A more holistic approach can serve as a starting point to solve fundamental architectural principles that inform how a modern digital banking solution should be designed (before any vendors are selected.) Deloitte Digital's experiences building these solutions have codified many of these principles. Some of these include:

- Design through a composite architecture lens
- Orchestrate in a BIAN-informed three-tier microservices architecture
- Modernize where relevant



Anchoring on these types of guiding principles creates the future-proofing mechanism and foundations for what, why, and how technology should be developed.

The value from modern digital banking

Players who have invested in modern digital banking architecture solutions have achieved noteworthy value. For example, some have achieved:

- Rapid prototyping (due to fewer integration complexities) to quickly meet constantly changing needs
- Lower operating costs (legacy cores drive manual processes, limiting simplification and automation)
- Increased reusability: ability to leverage 2/3 of cloud solution for a similar effort in another market[17]
- Low-code and no-code development capabilities which bring business users closer to the innovation and development
- Real-time environments
- Modular architecture with independent and interchangeable services that are reusable
- Infrastructure as code to support one-click environment deployments to quickly test and learn through new proofs-of-concept
- Strategic ecosystem of vendor partners to solve for the right capabilities

Conclusion

Our market experience suggests that the US digital banking landscape could be on the precipice of **major change.**

Incumbents need to rethink their priorities and propositions through a **digital lens.** New digital entrants need to focus on **balancing** raw customer growth with sustainable profitability. Non-banks need to foster robust **compliance and risk management** capabilities to remain compliant while leveraging their brand advantage.

Trade-offs will be inevitable throughout the journey, but winning with profitable growth mindsets that are balanced with execution capabilities will enable **success.**

Building an offering that links winning tenets in an end-to-end fashion will enable the development of a digital banking offering that is **desirable to customers, technically feasible, and operationally and economically viable.**

> Deloitte Digital has deep experience in **designing, building, and launching** winning digital banking propositions. **We are here to help.**

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