Digitalization Will Make Most Heritage Financial Firms Irrelevant

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By 2030, 80% of heritage financial firms will go out of business, become commoditized or exist only formally. Financial services CIOs should push their organizations for a more coherent response to digital business.

Impacts

- Digital disruptors will force CIOs in financial services firms to accelerate digital transformation.
- Digital ecosystem partnerships will enable disruptors to rapidly scale, and to offer more diversified services to challenge incumbents.

Recommendations

CIOs in financial services who are building or expanding a digital business:

- Act as a counterweight to the Hype Cycle by urging the CEO and business leaders to resist disillusionment and to accelerate their digital business efforts. Use examples of digital business platforms in financial services and other industries to demonstrate the speed at which transformation occurs once a tipping point arrives. The organization may not have time to change its traditional business and operating model once network effects kick in.
- Recommend a digital platform strategy to the CEO and business leaders based on your organizational size and ambitions. The largest firms should consider building a digital platform and a supporting ecosystem to drive scale and enable smaller firms to participate. Midsize and regional firms should either buy or merge with similar firms to gain scale for a platform play, or divest low-return businesses to focus on high-margin niches on other providers' platforms. Small firms should sell off commoditized products and services and become nimble fintechs.

Strategic Planning Assumption

By 2030, only 20% of heritage financial firms will flourish and win. Eighty percent will cease to exist, become commoditized or achieve zombie status.

Analysis

Since the 2008 financial crisis, financial services providers have underperformed. For U.S. banks:

- Return on equity has remained a flat 9.1% since 2012.
- Return on assets has remained at 1%, and this tracks as far back as 1992.
- The net interest margin is at a 30-year low of 3.1%.

Fintechs and nontraditional players, such as Alibaba and Metro Bank, are using digital technology to change the economics and business models of the industry.[1] Alibaba's Ant Financial, a full-service online provider, has more than 600 million customers with $300 billion in deposits. Lower costs and more efficient transaction platforms enable Ant to pay interest 150 basis points higher than traditional banks.[2] Metro Bank grew its revenue 62% in 2016, and customer accounts increased 40%.[3]

Established financial services providers will have to move faster on digital business by building digital platforms or finding niche products and services to sell on others' platforms. They face a growing risk of failure if they continue to maintain 20th century business and operating models. Financial services CEOs will increasingly turn to their CIOs for advice about digital business. CIOs should educate them about two impacts that digital business will have on their industry (see Figure 1).

Figure 1. Impacts and Top Recommendations for Financial Services CIOs

Impact Appraisal for Financial Services CIOs

Impacts	Top Recommendations
Digital disruptors will force CIOs in financial services firms to accelerate digital transformation.	▪ Urge CEOs to resist disillusionment and to accelerate their digital business efforts. ▪ Run a scenario planning exercise to learn the impact of digital business on the economics of your market.
Digital ecosystem partnerships will enable disruptors to rapidly scale, and to offer more diversified services to challenge incumbents.	▪ Recommend a digital platform strategy based on the size of your organization. ▪ Modernize and rationalize legacy systems, processes and data silos that create friction. ▪ Ensure the digital strategy stays on track by closely monitoring business returns.

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Source: Gartner (January 2018)

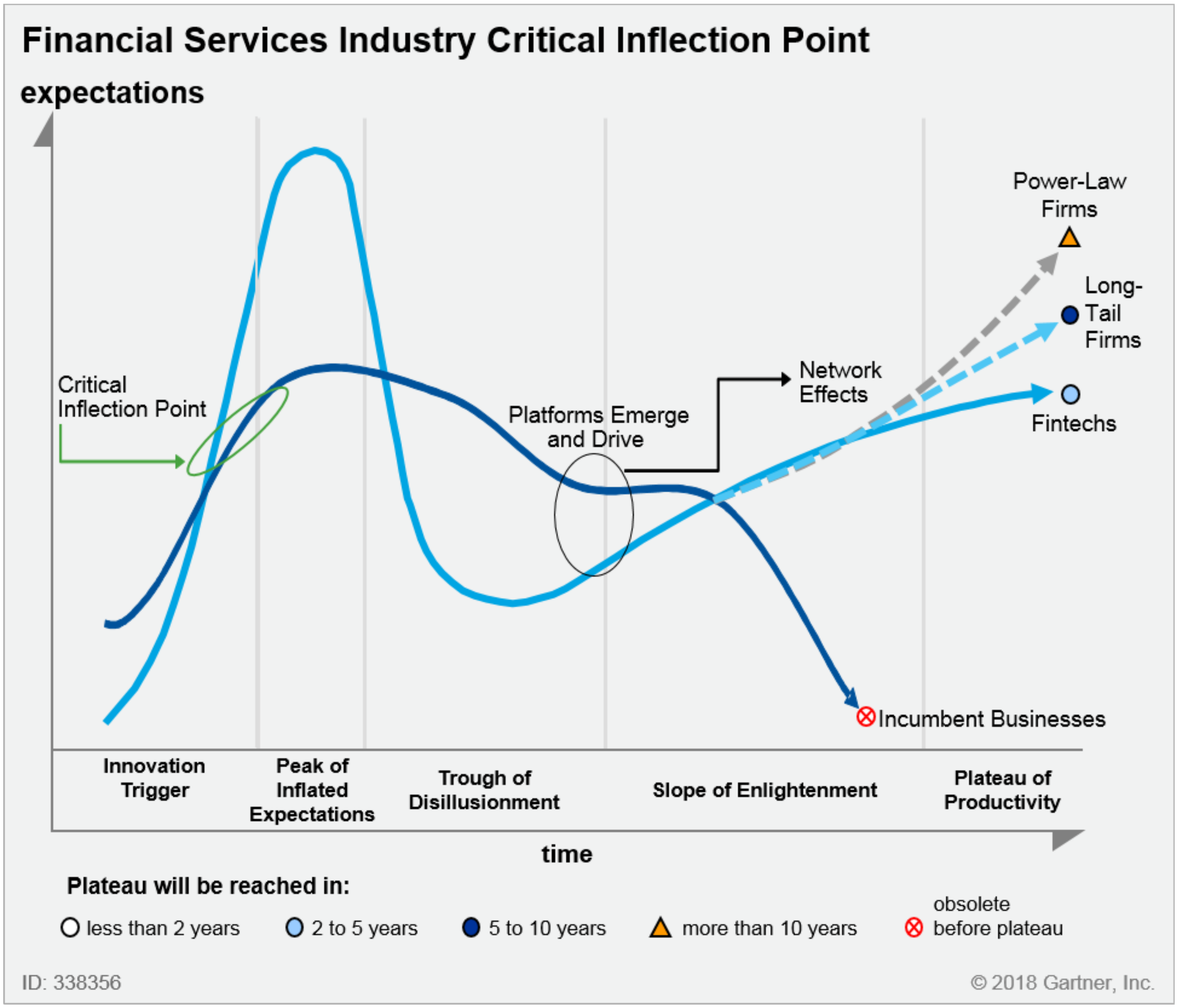
Impacts and Recommendations

Digital Disruptors Will Force CIOs in Financial Services Firms to Accelerate Digital Transformation

The future of the financial services industry is increasingly weightless, requiring few physical assets to establish or maintain a presence. That makes it especially vulnerable to disruption by digital competitors. Moreover, emerging technologies (such as blockchains) offer transformational opportunities by creating trust between parties that don't know each other, without intermediary relationships that incumbent financial firms cultivate (see "Maverick* Research: The Programmable Economy Is the Ultimate Destination for Digital Business"). Equally, peer-to-peer consensus algorithms can directly match borrowers to those with money, without requiring a bank to mediate. However, most financial services providers do not expect to transform digitally. Seventy-one percent of financial services CEOs believe that their organizations can compete in a digital world without changing their business model (see "2017 CEO Survey: A Financial Services Perspective").

This attitude is dangerous because it underestimates the degree of change that digital technology will bring to the industry (see Figure 2). We are in the middle stage of the transformation. The hype around digital business has peaked. A number of promising digital businesses have launched, supported by rapid growth in startup capital or by the deep pockets of large corporations. Few of these efforts have scaled up to industry-transforming levels, and they have yet to harvest significant returns, so we will soon hear about disillusionment with digital business. To this point, especially with interest rates improving, incumbent businesses believe they are safe.

Figure 2. The Future of Different Types of Financial Services Providers



Source: Gartner (January 2018)

However, the financial services industry will change quickly and dramatically after digital business emerges from the Trough of Disillusionment.[4] Heritage financial services firms are vulnerable:

- Their legacy systems cost more to run and are less flexible than the newer platforms of fintechs.
- Like Lyft and Airbnb, fintechs do not allow existing regulations to deter them, and, in some cases, regulators are already changing the rules to encourage new challengers.[5]
- Millennials and other consumers don't like to use traditional banks for all services.[6] Fintechs and alternative providers have capitalized on this opportunity to accelerate consumer lending and even corporate lending, starting with small and midsize companies.[7]

- Fintechs can iterate and improve new offerings quickly, while heritage providers must maintain the performance of their existing businesses to satisfy investors.

Only a few financial services providers will be able to scale up global digital platforms for multiple asset classes that bring together parties — initially from within their existing customer base, and eventually from across different industries — to complete commercial transactions. The more different stakeholders participate, the greater the volume exchanged on these platforms, and the lower the unit costs. Eventually, these platforms will reach a critical mass and begin to achieve self-reinforcing growth. We could see these network effects as early as 2025.

The economics of traditional incumbent businesses will cease to work as margins erode. Eighty percent of the roughly 45,000 existing traditional financial firms are, therefore, likely to struggle for relevance as these global digital platforms gain greater market share. We recognize that, in some countries, governments may choose to act to maintain the status quo. However, without government intervention, many heritage financial firms will go out of business, be forced to merge or achieve "zombie status" (that is, formally existing, but not competing effectively). Certainly, maintaining any underlying, long-term profitability will prove to be impossible. Of the 20% of traditional firms that remain as winners, three types will flourish:

- **Power-law firms:** Companies that own a digital platform will use its scale, low-cost infrastructure and the customer information it generates to create new services and enter new markets. For example, Alibaba used the knowledge it gained from its e-commerce platform to offer low-cost loans to Chinese consumers who did not have credit scores. Only very few of these winning heritage institutions, perhaps 5% or 450 firms, have the ability to become power-law firms.
- **Fintechs:** Individual companies or pure-play/neobank subsidiaries will disaggregate traditional financial services in discrete product areas. They will participate in digital platforms, but will not own them. Less than 15% or 1,350 of the winning group of traditional financial firms can convert themselves into, or successfully spin off, fintechs.
- **Long-tail firms:** The dramatically lower costs enabled by digital platforms will allow some traditional providers to act as service brokers. This is likely for large populations of poor and working-class people around the world that were not profitable customers previously. Simultaneously, they can act as concierge providers of bundled offerings to high-net-worth individuals. Some incumbents have moved in this direction. Barclays has increased its focus on financial inclusion, while Rabobank is focusing on alleviating food poverty.[8] Long-tail firms will also include a limited number of institutions competing on non-cost-based parameters. These could include specific brand commitments, such as sustainability or charitable obligations, or geographic localization. Around 80% or 7,200 of that winning 20% of traditional financial services providers can become long-tail firms.

The speed of digital transformation in financial services partly depends on regulation as well as customer demographics and behaviors, which will vary from country to country. In some nations, conservative regulations will inhibit innovation, while other countries (such as Australia, Brazil, China, India and the U.K.) will use regulation to speed transformation. For example, the revised

Payment Services Directive (PSD2) in Europe requires financial institutions to open up their back-office processing systems for integration with fintechs.

A substrata of banks below the platform players at the community level can sustain the community financial services model without necessarily having a singular focus on profitability. While some community banks may consolidate and will have to improve efficiency, their concentration on personalized products and services could address customer value propositions that aren't totally price-sensitive, such as physicality, location, personal relationships and education. These offerings could develop in a similar fashion to the artisan and craft business models seen in other industries.

Recommendations

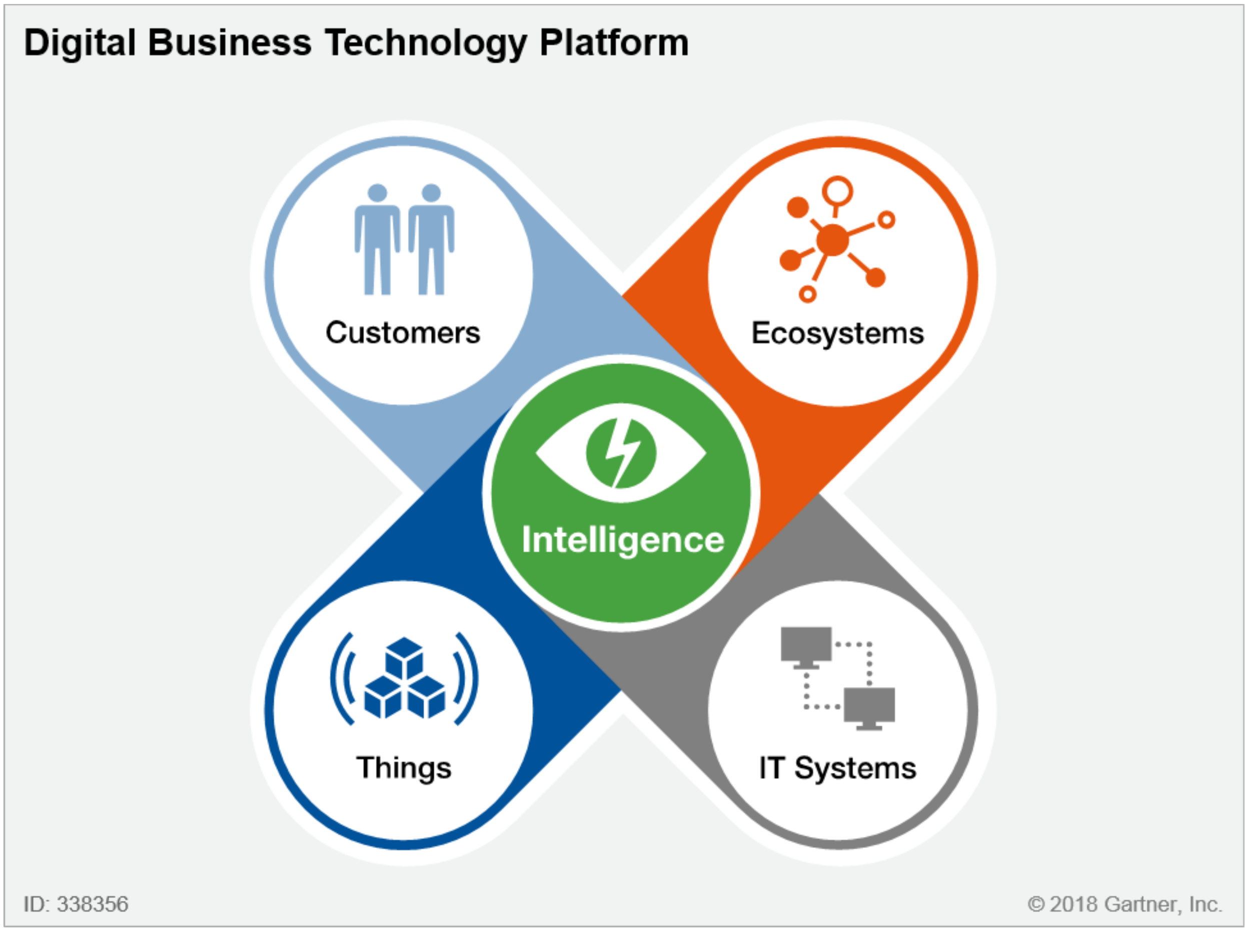
Financial services CIOs:

- Act as a counterweight to the Hype Cycle by urging the CEO and business leaders to resist disillusionment and to accelerate their digital business efforts based on how your firm aligns with one of the scenarios in Figure 2. Use Figure 2 and examples of digital business platforms in financial services and other industries to demonstrate the speed at which transformation occurs once a tipping point arrives. The organization may not have time to change its traditional business once network effects kick in.
- Work with the business to run a scenario planning exercise in which you consider the impact of digital business on the economics of your market, products and services. For example, what would happen if transaction margins fell 90% over five years? Think about the ramifications of the Single Euro Payments Area. Consider how to mitigate the risk from lost revenue, but, equally, consider what new opportunities might open, such as scaling up a niche offering or expanding your customer base.

Digital Ecosystem Partnerships Will Enable Disruptors to Rapidly Scale and Offer More Diversified Services to Challenge Incumbents

Most digital businesses will operate on a digital business technology platform (see Figure 3 and "Building a Digital Business Technology Platform").

Figure 3. The Digital Business Technology Platform



Source: Gartner (January 2018)

AXATP, which is AXA's property and casualty subsidiary in China, illustrates the gains that a digital platform can provide (see "Gartner's 2016 Eye on Innovation Award Winners Demonstrate Leading-Edge Financial Services Capabilities"). The company wanted to increase its market share by selling insurance end-to-end through online channels. Its solution included:

- A cloud-based digital insurance platform to achieve flexibility to launch new and segmented products
- Analysis of customer data, including from social media, to deliver customized pricing, marketing and engagement, and targeted products and offers, automatically rendered on any device
- Multichannel connectivity and online campaign management for enhanced customer experience and retention

AXATP developed the capacity to collect and analyze big data, such as by adding analytic skills and improving data quality. It collaborated with third parties for such things as rating, payment and content in an open digital ecosystem. It exploited the latest user-interface and user-experience concepts to optimize the customer experience and promote sales. As a result, AXATP:

- Achieved a high availability and response rate to sell insurance entirely online.
- Increased speed to market by three times while decreasing costs by 30 times.
- Can launch a new insurance product in one to two days.

However, digital platforms will ultimately extend beyond the scale of a single company. Such platforms will:

- Involve multiple buyers and sellers, and possibly other stakeholders (such as partners, suppliers, nonfinancial entities, citizens and regulators).
- Have scale via national, regional and/or global reach.
- Achieve economies of scale that are not possible with single-company platforms.
- Facilitate the exchange of many different products and services.
- Challenge traditional industry boundaries by extending into far markets.

Every industry will have room for only one or two digital business platforms per region or per product category. The platform owners will reap the biggest rewards, but the platform will create opportunities for other players, too. Only the largest financial services providers have the scale and capabilities to build a sustainable platform on their own. Possibly companies outside the industry will build or extend a platform into financial services.

Some platforms are already being built. For example, Broadridge runs digital platforms that support multiparty services for financial services providers and other industries.[9] These services include securities processing, shareholder communications and voting, and asset services. The platforms serve all the parties involved — for example, voting connects the corporation, shareholders and regulators. Broadridge aims to build platforms at global scale that can handle multiple asset classes. Thus, the platform could be a less expensive alternative to the back-office systems and single-purpose platforms that financial services providers would have to build and maintain themselves.

Recommendations

Financial services CIOs:

- Recommend a digital platform strategy to the CEO and business leaders based on your organizational style and ambitions. The largest firms should consider building a digital platform and a supporting ecosystem to drive scale and enable smaller firms to participate. Midsize and regional firms should either buy or merge with similar firms to gain scale for a platform play, or divest low-return businesses to focus on high-margin niches on other providers' platforms. Small firms should sell off commoditized products and services and become nimble fintechs.

- Modernize and rationalize legacy systems, processes and data silos that create friction and barriers to business partners and customers. Discard what you can and modernize what you must keep. Foster openness in the platform via an API strategy (see "Design an API Mediation Layer to Underpin Your Digital Business Technology Platform"). Promote more porous institutional boundaries both internally and externally to encourage collaboration and allow for the capture of new business opportunities.
- Ensure that the digital strategy stays on track by closely monitoring business returns. Leading CIOs spend up to 70% of their time "in the business" and "with the business." All CIOs should aspire to this goal.
- Don't overlook other sources of digital disruption. In particular, blockchain could make even the platform players irrelevant in 10 years (see "Maverick* Research: How Blockchain Undermines the Value Proposition of Platform Businesses").

Gartner Recommended Reading

Some documents may not be available as part of your current Gartner subscription.

"2017 CEO Survey: A Financial Services Perspective"

"Hype Cycle for Digital Banking Transformation, 2017"

"Building a Digital Business Technology Platform"

"Design an API Mediation Layer to Underpin Your Digital Business Technology Platform"

"Fire Yourself as CIO and Hire Yourself as a Digital Business Leader"

"Ten Practical Lessons CIOs Can Learn From Venture Capitalists"

Evidence

This report is based on primary and secondary research into the state of digital business in the financial services industry, as well as on Gartner's general research into digital business, digital platforms, the CIO role and culture change.

[1] See "A New Landscape: Challenger Banking Annual Results," KPMG.

[2] See "China's Digital-Payments Giant Keeps Bank Chiefs Up at Night," The Economist.

[3] See "Metro Bank on Track for First Full-Year Profit," Financial Times.

[4] See "Direct Lending Dawns in Europe," Global Risk Insights.

[5] See "New Breed of UK Start-Up Banks Force Licensing Rethink," Financial Review.

[6] See "Why More Millennials Would Rather Visit the Dentist Than Listen to Banks," Forbes.

[7] See "PayPal Says It's Loaned $500M to Small Businesses in the Past 18 Months," FinTech Ranking.

[8] See "Banking on Change: Breaking the Barriers to Financial Inclusion," Barclays, Plan UK and CARE International UK; and "Banking for Food: Vision on Global Food Security and the Role of Rabobank," Rabobank.

[9] See "Tim Gokey on Industry Transformation," Global Custodian.

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