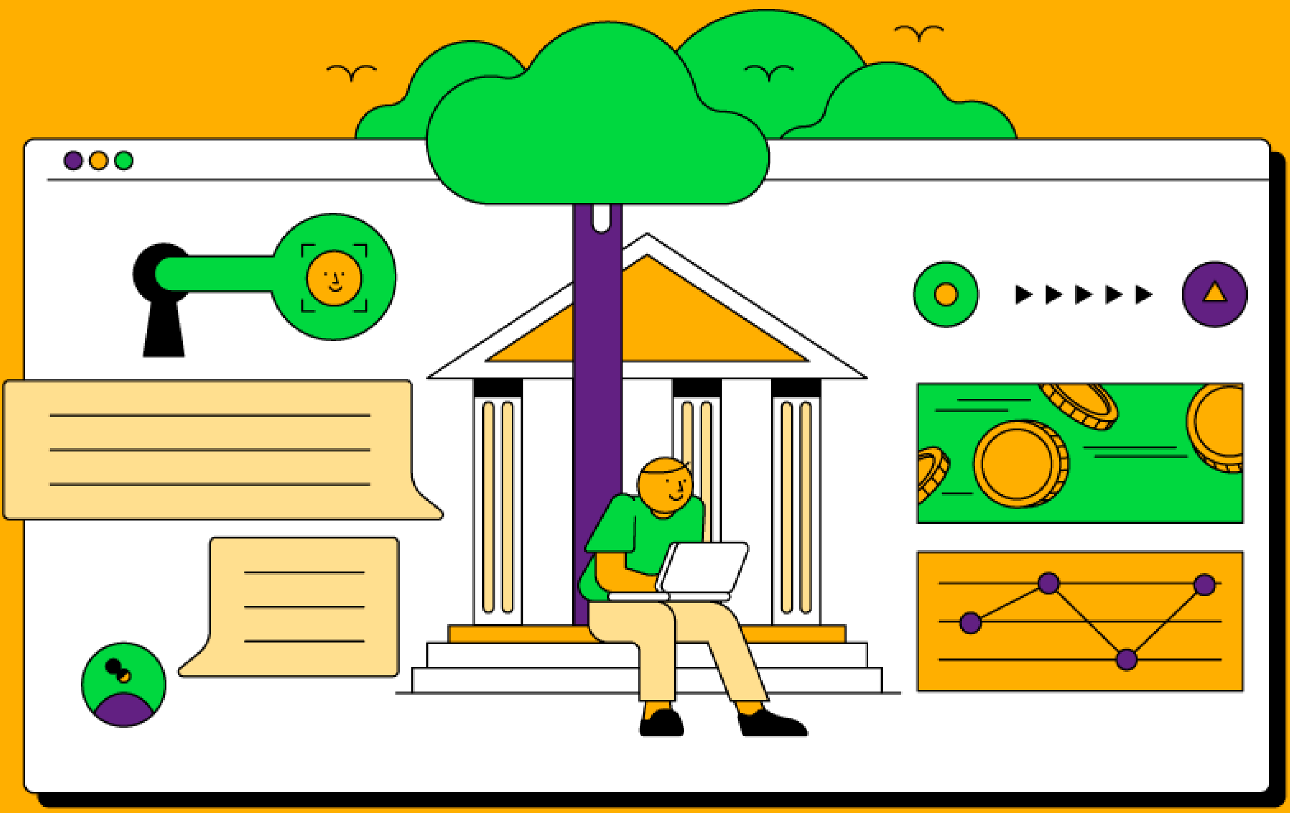
Raconteur

Fit for the future: how tech is transforming the banking industry



NatWest

Contents

Are traditional banks wrestling back control of their destiny?

Banking is set to change, with traditional banks evolving and, despite predictions that technology firms will take over, are set to keep a firm footing due to the trust their customers place in them

High street banks are taking back control from fintech disruptors, like veteran arm wrestlers outlasting the younger competition.

But they're having to transform radically to achieve it.

Traditional banks will dominate the industry in 2030 but will look different, according to 2023 research. Despite predictions that technology firms will take over, 69% of UK technology and banking leaders think that banks will assert their ascendance, mainly because customers trust them more than technology companies.

But the research, by PA Consulting, reveals another threat. The growing financial services market share of big techs such as Apple, Amazon and Google will force banks to digitise further to remain competitive.

How to combine the best of neobanks and incumbents

Jason Hill, head of banking at PA Consulting, says banks are continuing to respond to these challenges by accelerating technology investment to make services more flexible, cost-effective and customer-centric. They are also learning from others, for example, Amazon's customer experience; and partnering with fintechs to integrate innovative solutions.

According to the research, 71% of leaders expect traditional banks to act as customer-facing operations, with other players driving back-end operations. It will mean banks need to keep a close eye on their position in an increasingly fragmented market.

Tom Merry is managing director of banking strategy at Accenture and says this landscape will lead to an "era of convergence".

"Neobanks have struggled because they have amazing customer engagement and technology but don't have the balance sheet to scale revenues," he says. "Incumbents have the scale and product diversification but were running on legacy technology. We see an era in which the two converge towards a digital-first model, with all the benefits of modern architecture, plus a deep balance sheet.

"Digital players and banks will come together in an API-enabled way – for example, to give you easy, competitive foreign exchange when you go on holiday."

It requires incumbents to evolve their estate towards modern architect, cloud-based, API-enabled technology, and manage down old systems safely, says Merry. That is still a challenge and requires some breaking of the estate into constituent parts. Rather than changing everything with a big bang, banks are "eating the elephant bit by bit", he says.

Purpose as edge

Another differentiator for traditional banks is that they prioritise environmental, social and governance (ESG) and the ability of finance to support sustainability more than tech firms, says PA Consulting. Banks cannot afford to de-prioritise this issue as social and environmental risks are among their gravest long-term threats.

Hill says banks have again responded by renewing their focus on purpose, emphasising positive social impacts and aligning strategies with stakeholder needs. Purpose-driven banking helps foster a sense of direction and enables innovation, he says. We explore this move to purposeful banking in Article 3, 'How to seize the opportunities of purposeful banking'.

Outstanding challenges

Banks still face many obstacles to innovation. They often struggle with onboarding fintech partners due to differences in language, risk assessment, and operational needs. They struggle to find the necessary skills, such as in AI and customer experience design.

But banks are addressing these challenges by improving their technology infrastructure, enhancing risk assessment, streamlining onboarding processes, rethinking their talent pool, and upskilling employees.

Do customers want AI or human connections?

The rise of generative artificial intelligence is also boosting innovation. Banks are exploring the use of AI to personalise customer experiences, improve risk assessments, and provide seamless and secure services.

Eduardo Roma, a partner in Bain & Company's financial services and customer strategy practices, says: "Much has been said about the impact of AI in banks, for example, with bots interacting with customers, frontline advisers becoming more productive, and middle- and back-office automation. AI-enabled customer engagement could help companies learn from each interaction to create more customer value. But the technology demands a different way of thinking, and the risk is productivity at the cost of customer experience.

"In tight economic times, managers may misguidedly use AI only to cut costs – but the greatest value will come to those that focus on enriching customers' lives."

Supporting customers' financial wellbeing

Unpublished research by Bain shows customers want and expect their bank to play a much more prominent role in their financial wellness and education – for example, helping manage their money and improve financial independence. Despite much information and tools being available, a lack of personalised connection and support can leave people feeling isolated.

"Solving this doesn't necessarily mean full digital support," says Roma. "Banks need to figure out the future role of branches in helping customers enhance financial wellbeing."

Customers feel bank branches have lost their humanity, and banks need to empower staff to create human connections, he says.

Banks also have huge challenges to support younger customers who face student debt mountains, are stuck in rental traps, and need to manage higher living costs. Banks can tackle these issues through creative solutions such as more flexible mortgage repayments, and support with reduced mortgage repayments, says Roma.

Unimaginable growth opportunities for banks

Another factor driving innovation right now is the evolving finances of banking players. Fintech funding and valuations have fallen dramatically. In contrast, rising interest rates propelled bank profitability to a 14-year high, according to McKinsey.

This profitability growth enables banks to make long-term structural investments in technological innovations that will reshape their business models and open opportunities that were unimaginable a few years ago.

Banks tool up for the future of payments

The shift from cash to electronic and online transactions has driven banks to digitise their processes, improve user experience, and introduce safer and more streamlined payment products and methods to meet customer expectations

The payments landscape is changing dramatically, and banks are responding with enhanced solutions.

Evolving customer expectations and the ongoing shift from cash to electronic and online transactions have catalysed banks to digitise their processes, improve user experience, and introduce safer and more streamlined payment products and methods.

Another driver has been the challenge from fintechs. Sulabh Agarwal, global payments lead at Accenture, says: “Fintechs have been successful in payments – for example, in international money movement, remittances and embedded finance. We will continue to see banks investing in their payments to compete. They can create lots of value with their larger customer base and broader product range compared to fintechs.”

Banks have a huge opportunity to bring together parts of the customer journey, adds Agarwal. For example, a merchant acquiring solution enables payments but it could also enable lending to corporate customers. The key is to integrate those things at the point of customer need, which is easier for banks, he says.

New value creation opportunities

Miklós Gábor Dietz, senior partner at McKinsey, says examples of more secure, efficient and personalised payment solutions from banks include linking corporate customers to accounting software, working capital solutions, digital commerce and industry-specific software. For individuals, examples include linking them to digital identity tools, fast and convenient cross-border payments, or embedded payments.

These changes require continued investment in technology, such as increasing adoption of real-time payments and open banking, says Dietz. But the result is that banks’ technology infrastructure can often now contribute to value creation for banks and their customers in numerous ways, such as through invoicing apps, merchant acquiring gateways, or buy-now-pay-later services.

Mark McMurtrie, director at Payments Consultancy, says fighting payments fraud has also become a pressing priority for banking innovation, particularly since authorised push payment (APP) frauds have rocketed.

“In a digital world, money moves extremely fast and easily across national borders,” says McMurtrie. This has enabled fraud to escalate dramatically, causing high costs for banks and customers.

“Banks have invested massively in financial crime compliance programmes but need new thinking to keep up with the criminals,” says McMurtrie. “Technologies like machine learning, biometrics and strong customer authentication can rebalance the playing field.”

Readying for the global financial standard

The ongoing implementation of the payments messaging standard ISO 20022 is another factor which is creating numerous challenges and opportunities for banks. It enables them to exchange payment information more seamlessly, leading to faster and more reliable transactions.

McMurtrie says ISO 20022 is powering real-time payment systems, allowing more data to attach to each payment instruction, and creating new product opportunities and controls. For example, corporations are excited about the opportunity to embed invoicing details with each payment, simplifying the funds reconciliation process, he says.

David Gunn, a partner in Bain & Company’s Financial Services practice, agrees, adding that other benefits will include fewer exceptions or rejected payments, and more straight-through processing, reducing costs, plus other currently unforeseen long-term benefits.

> “Banking interfaces will likely include extra data on invoices, marketing details and further contextual information
>
> Mark Kane, financial services expert, PA Consulting

Mark Kane, a financial services expert at PA Consulting, agrees that ISO is a huge opportunity. But he notes that it is also causing significant disruption in overhauling national infrastructure, internal systems and decades of knowledge rapidly.

“We expect banking interfaces to change to include the extra data on invoices, marketing details and further contextual information,” Kane says. “This change could be overwhelming for customers as banks start communicating what ISO means for them and how the once straightforward process will evolve overnight. But all participants can benefit by leveraging the increased data.”

If they haven’t already, banks should start considering how they want to leverage these benefits, says Kane. This could be through more efficient transaction monitoring or new value propositions for customers. Banks should also be educating corporate customers – including big tech firms and retailers – about their operational readiness for ISO 20022 and how they plan to use the additional remittance and contextual data.

Further innovation in payment products

Gunn says banks are still focusing on the changes required to deliver compliance with ISO 20022, as well as the UK’s New Payments Architecture – the proposed new method for clearing and settling interbank payments – rather than developing new, innovative products and customer experiences. The complexity and risks of these programmes absorbs most of the available investment.

But, despite this, banks increasingly recognise the strategic importance of strong payment products to support wider business banking relationships, says Gunn. This is driving the development of more integrated propositions that combine transaction banking, payments acceptance, and accounts payable and receivable functionality into a unified experience.

“For incumbent banks, this is a critical defence against losing market share to challenger banks and fintechs,” he says.

How to seize the opportunities of purposeful banking

Environmental, social and governance (ESG) is a priority for businesses looking beyond profit – banking must work hard to introduce purpose to their processes – and meet sustainability targets

What's your purpose? Many banks are evolving theirs beyond driving profits for shareholders, towards positive social and environmental impacts, fuelled by growing evidence that it's not just a moral choice, but also a competitive driver.

For example, 2021 research by Accenture found positive correlations between purpose-driven strategies and financial performance and market valuations for banks.

Wider purpose is also a way to help banks retain trust, which – as highlighted in Article 1, 'Are traditional banks wrestling back control of their destiny?' – is a critical tool in their battle to maintain market share. But some banks have been late to evolve their purpose towards environmental, social and governance (ESG) goals, and there is much work for the industry to catch up with other sectors.

Set sustainability targets

Peter Ward, partner, financial services, at LEK Consulting, says: "Consumers want greener financial services, for example. But there is still a relative lack of such services in the UK, including discounts on products or services linked to more ethical behaviour, or that directly support the energy transition. But this is coming, and as more firms adopt a green purpose, incumbent and challenger banks alike will have to respond or lose customers."

Ward says progress on sustainability targets is less advanced in financial services than in primary industries because their direct impacts are lower. But greater emphasis from regulators and customers on curbing greenhouse gas emissions, for example, is pushing banks to put greater resources into measuring and reducing impacts.

Five years ago, sustainability targets were driven mainly by internal groups of like-minded volunteers, adds Ward. But more action is now required with dedicated, well-funded teams and sponsorship from senior leadership.

Steven Lizars, sustainable finance partner at Deloitte, says: "The focus for banks is still on meeting net-zero emissions targets. However, banks are also considering the intersections of climate, nature, biodiversity, and the 'just transition' [to net zero in a way that's fair to all sectors of society]. To meet these targets, banks are incorporating Transition Plan Taskforce recommendations into their plans.

"They are considering governance issues, and customer and government engagement; and innovating products to align with sustainability goals, such as offering green mortgages. Plus they are responding to demand for more responsible practices on diversity and inclusion."

Benefits for conscious consumers

PA Consulting research shows that 67% of banking leaders see the "conscious consumer" at the centre of their future business models. This means aligning products, such as mortgages and investments, with customers' ethical views so that they feel their investments support initiatives which are important to them.

Banks are exploring partnerships in this area too, for example, embedding finance with electric car hire or green energy providers, to support customers in making more ethical choices.

Institutions also need to check whether all their suppliers and partners, such as fintechs, meet ESG standards by using clear materiality assessment frameworks and due diligence during procurement and ongoing. Transparency over ESG targets with partners will be vital.

Be clear on greenwashing

Pressure from regulators, customers and investors to avoid greenwashing – claiming false green credentials – remains high. In recent research by law firm Leigh Day, 75% of people said they wanted harsher penalties for corporations caught making false claims. The Financial Conduct Authority (FCA) has also proposed new rules to tackle greenwashing.

Lizars says: "Greenwashing is a top regulatory priority. Banks are reviewing their practices, including product promotion, partnerships, and governance, to ensure they are credible and fair. One challenge is avoiding subcategories of greenwashing, such as 'green lighting', which means highlighting good impacts and downplaying bad ones."

New sustainable finance products

Another way to drive purpose for many banks is to develop sustainable finance products that consider ESG factors in an investment bond, for example.

Over the past five years, sustainable finance has grown to become a major theme for banks. McKinsey says this is set to grow further to support the global transition to green energy, with annual direct financing opportunities of about $820bn (£626bn), plus $1.5tn of investments for corporates between 2021 and 2030.

Miklós Gábor Dietz, senior partner at McKinsey, says to capture these opportunities, banks need to address critical issues.

"Only a small percentage of banks have near-term capabilities to finance burgeoning areas such as grid-scale infrastructure, green fuels, and carbon capture and storage," he says. "Challenges include credit risk, complex project economics, and lack of established standards for sustainability-related products. But new instruments, markets, and revenue pools beckon for banks who step willingly into the next era of sustainable finance."

COMMERCIAL FEATURE

Q&A
Banking on digital transformation

Innovation and the regulation of data will speed up payments, improve customer experience and protect industry and customers

Digital change brings many challenges and opportunities in banking and payments, as providers balance implementation with maintaining service standards. NatWest is transforming in many areas, including customer experience digitisation, data equity and flow, and the cloud. Meanwhile, payments network Swift is introducing international data standards and a service that allows fast, secure cross-border payments for small businesses.

Ian Povey, CIO, payments technology at NatWest; and **Nick Kerigan**, managing director, head of innovation at Swift, explain how they think banking modernisation will unfold over the next few years.

Q What challenges and opportunities does digital transformation bring to banking?

IP Global pressures, including the rise of fintech and evolving customer expectations, drive us to continuously innovate, modernise and improve our offerings. This innovation is crucial for NatWest to differentiate.

The challenges and our focus lie in modernising our technical assets, operational processes and products to meet today's digital needs. We have to bring the whole bank, the regulators and the industry with us on that modernisation journey.

A culture of experimentation and willingness to fail fast is important. This has supported our successful innovations in open banking with Payit, our e-commerce solution; and Tyl, our merchant acquiring proposition.

We are also using further innovations in data to speed up payments, improve customer experience and build protections for industry and customers.

NK At a fundamental level, all aspects of our lives are becoming digital. No industry will be untouched by this digital transformation. The biggest opportunity and challenge in a digital economy is consumers' and businesses' heightened expectations for speed, convenience and payment predictability. Swift has responded with significant innovations, including leading on migrating to new standards such as ISO 20022 [the new payment messaging standard] for cross-border payments. This standard is also being adopted by regional systems such as T2S [the European real-time settlement system] and national systems like CHAPS [the sterling same-day settlement system].

Q What changes are ongoing, and what outcomes do you expect?

IP We are implementing ISO 20022, which will provide more structured and richer data for faster, easier and more reliable payments.

Data equity and data flow are also critical. With ISO 20022, we can ensure data is available at the right time and place to improve customer experience. Artificial intelligence tools can also use this data to enhance fraud detection and protection.

We embrace regulation as a tool for change in banking, for example, improving the payments ecosystem and protecting its integrity. This helps enhance customer trust and ensures secure and efficient payment experiences.

Another issue is that, in recent times, remote working has become a necessity. To this end – and to maintain robust security – we have adapted our systems and processes to enable our employees to work remotely, while ensuring the highest security and data protection.

We are also expanding our services in open banking, embracing instant and real-time payments, and building protections for the industry and customers.

In future, we plan an 'always-on' payments model, which means ensuring real-time data is available to ensure the best possible customer experience and control over payments. We also aim to allow customers to track their payments at any time, similar to tracking a package on Amazon.

NK The industry's migration to ISO 20022 has already started. The standard provides rich, structured data, enabling faster and more reliable cross-border payments. This will bring profound benefits in increasing the efficiency and transparency of payment processing. For example, by providing more accurate data about payments the standard can help banks avoid many sanctions and anti-money-laundering false positives, which often slow down payments currently.

Another innovation is the introduction of our new Transaction Manager platform to preserve data integrity and improve payment flows. This platform preserves ISO 20022 data throughout the payment process, even if not all banks in the chain are ISO-ready. It also facilitates end-to-end tracking and payment orchestration, speeding up payment flows.

We have also introduced Swift Go, which aims to provide a better experience for consumers and businesses by enabling fast, secure lower-value cross-border payments worldwide.

Plus, we are exploring AI, central bank digital currencies and tokenised assets, which could all reshape the payments landscape.

Q What pain points and solutions have you encountered in these transformations?

IP We need to respond to consumers' and businesses' expectations for faster and more convenient payments with tools and capabilities to enable low-friction, instant payments while maintaining security and reliability.

Harmonising payment messaging and exchanges across different standards is crucial for faster and more effective customer protection across countries and to improve efficiency.

Education is also an ongoing challenge to keep regulators, executives and customers informed about the evolving digital landscape and help them respond.

Ensuring a smooth transition while minimising service disruptions is akin to 'rewiring with the lights on'. But by understanding the ecosystem and timing of events, we can safely advance payment systems without disrupting service standards. Our successful migration of high-value payments to ISO 20022, which has just happened, reflects our ability to do this, as does our recent migration to Swift and T2 settlement in Europe.

> ISO 20022 has already started. The standard will provide richer, structured data, enabling faster and more reliable cross-border payments
>
> Nick Kerigan, managing director, head of innovation, Swift

Q What is cloud technology's role in payments transformation?

IP Cloud technology allows us to adapt our payment systems and scale to handle increasing demand and data volumes. It also increases payments speed and flexibility and supports our climate change agenda by reducing energy consumption.

However, it is essential to balance that with control over important services by owning data centres for resilient services. So we take a balanced view and use cloud technology where it is most effective.

Q How can you meet the increasing need to mitigate fraud as faster payments become the norm?

NK Swift is investing heavily in a state-of-the-art AI platform that can handle large volumes of transaction data to provide advanced anomaly detection, which will be used by our member banks to identify fraud and other issues. We believe that no good comes out of fraud and addressing it requires a collective effort. Pre-validation services, structured data, AI and customer education are vital tools.

IP Mitigating fraud requires a balance between adding friction to the payment process to allow time to detect and prevent fraudulent activity, and providing a seamless and convenient user experience.

But friction is not the only solution. Education, structured data, pre-validation, aliases and AI can also help detect and prevent fraud. NatWest is also exploring AI to enhance fraud detection and provide a more secure payments environment.

We educate customers to prevent scams and we embrace structured data and harmonisation across payment standards to help detect anomalies and protect customers.

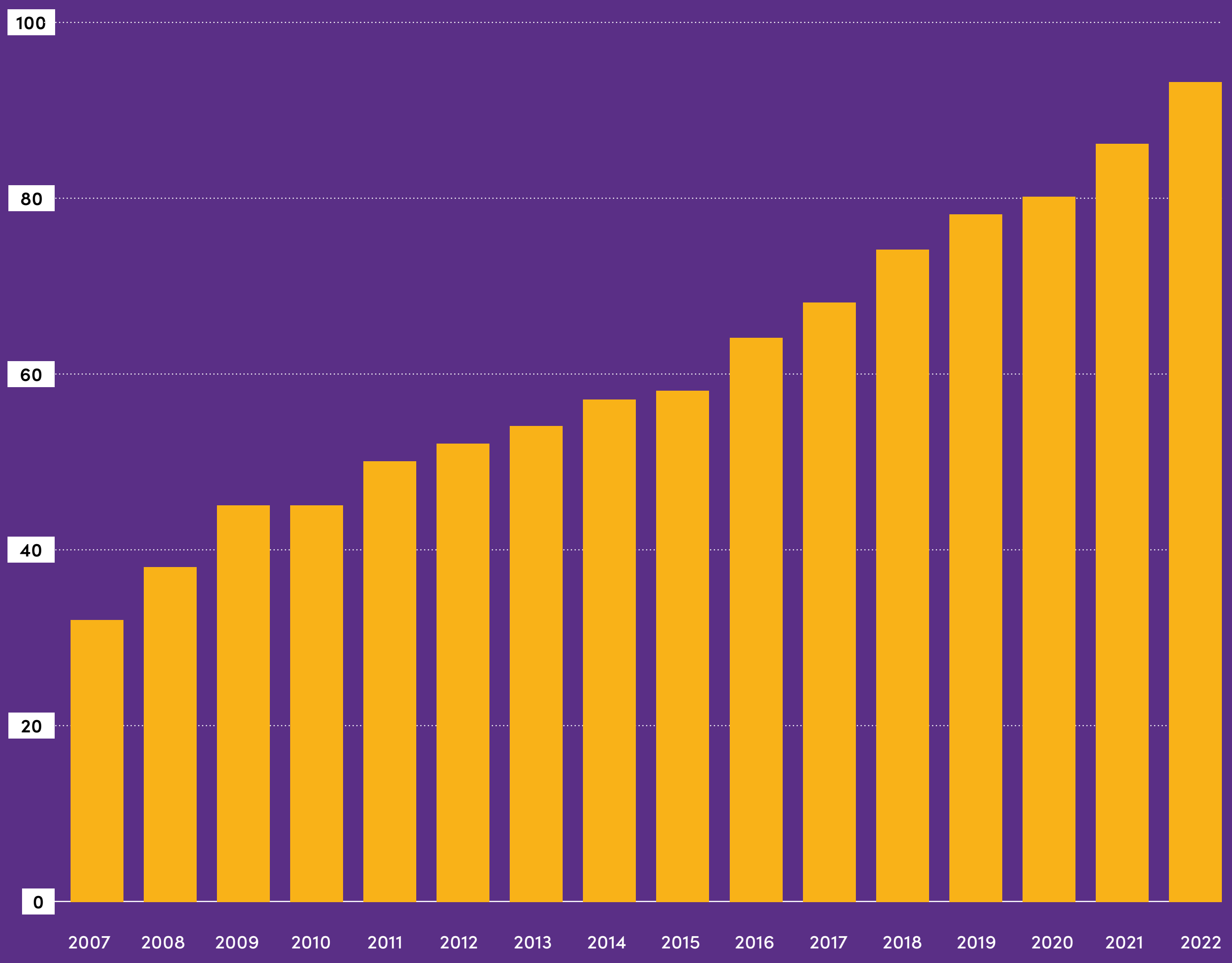
Banking's race to become digital champions rather than also-rans

The way customers use banks is evolving as tech comes to the fore. There is progress to be made when it comes to ESG and accessibility – and banks must be sure to take their clients with them on their journey of digitisation

IN 2007, AROUND ONE THIRD OF THE BRITISH POPULATION USED ONLINE BANKING, WHICH INCREASED TO OVER 90% IN 2022. BANKING AND FINANCIAL SERVICES ARE TYPICALLY AMONG THE FIRST INDUSTRIES TO EMBRACE TECHNOLOGICAL ADVANCES

Share of people using online banking in Great Britain 2007-2022

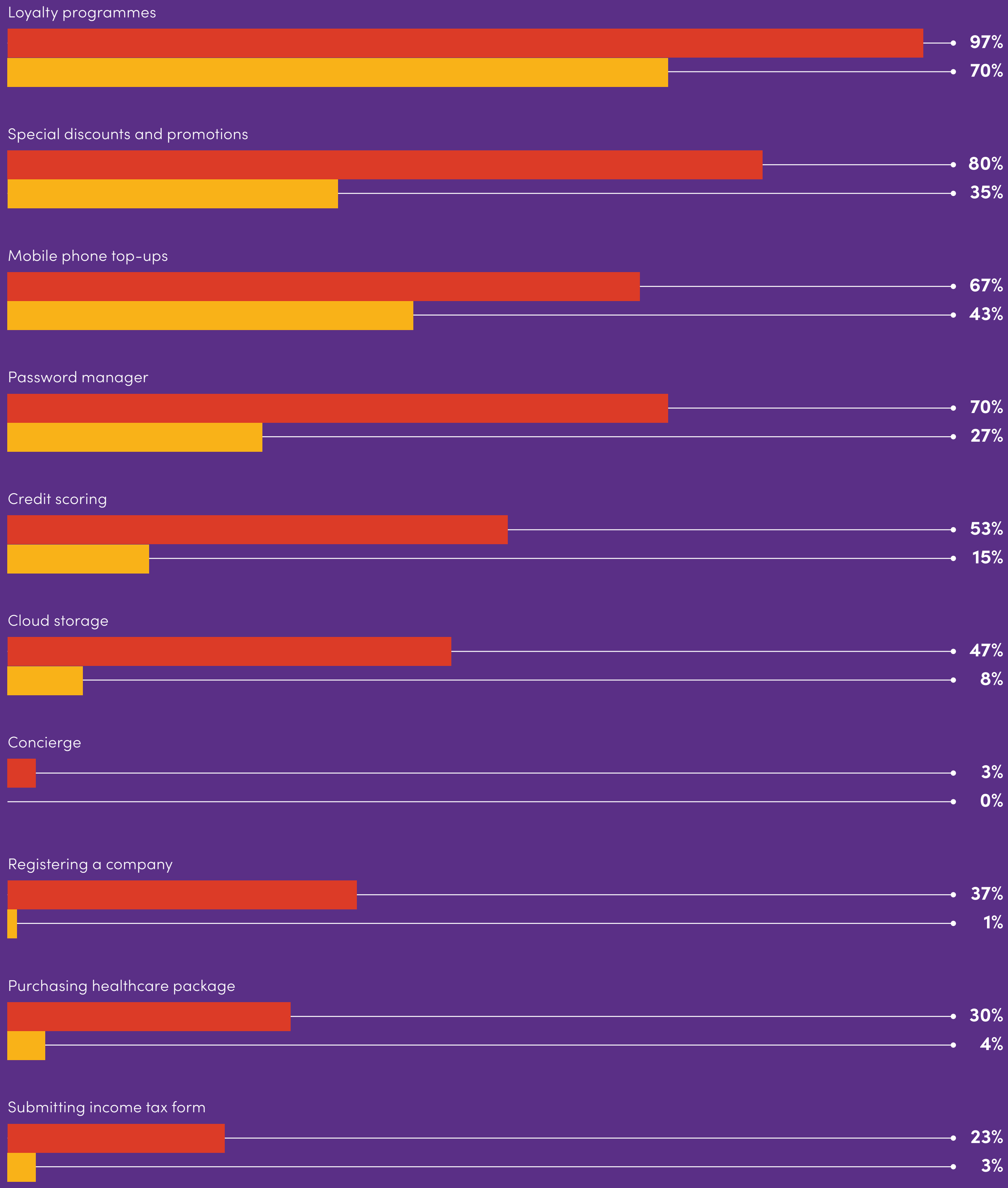
Stastista 2023



VALUE ADDED SERVICES ARE A DIFFERENTIATOR, ADOPTED MAINLY BY BANKS WHO ARE DIGITAL CHAMPIONS. THESE BOOST CUSTOMER ENGAGEMENT AND LOYALTY, HELPING BANKS TO ACQUIRE AND RETAIN CUSTOMERS. THEY CAN ALSO PROVIDE BANKS WITH NEW CUSTOMER DATA, ENABLING PERSONALISATION AND THE CROSS-SELLING OF FINANCIAL PRODUCTS

Top value added services by category, percentage of banks offering given functionality

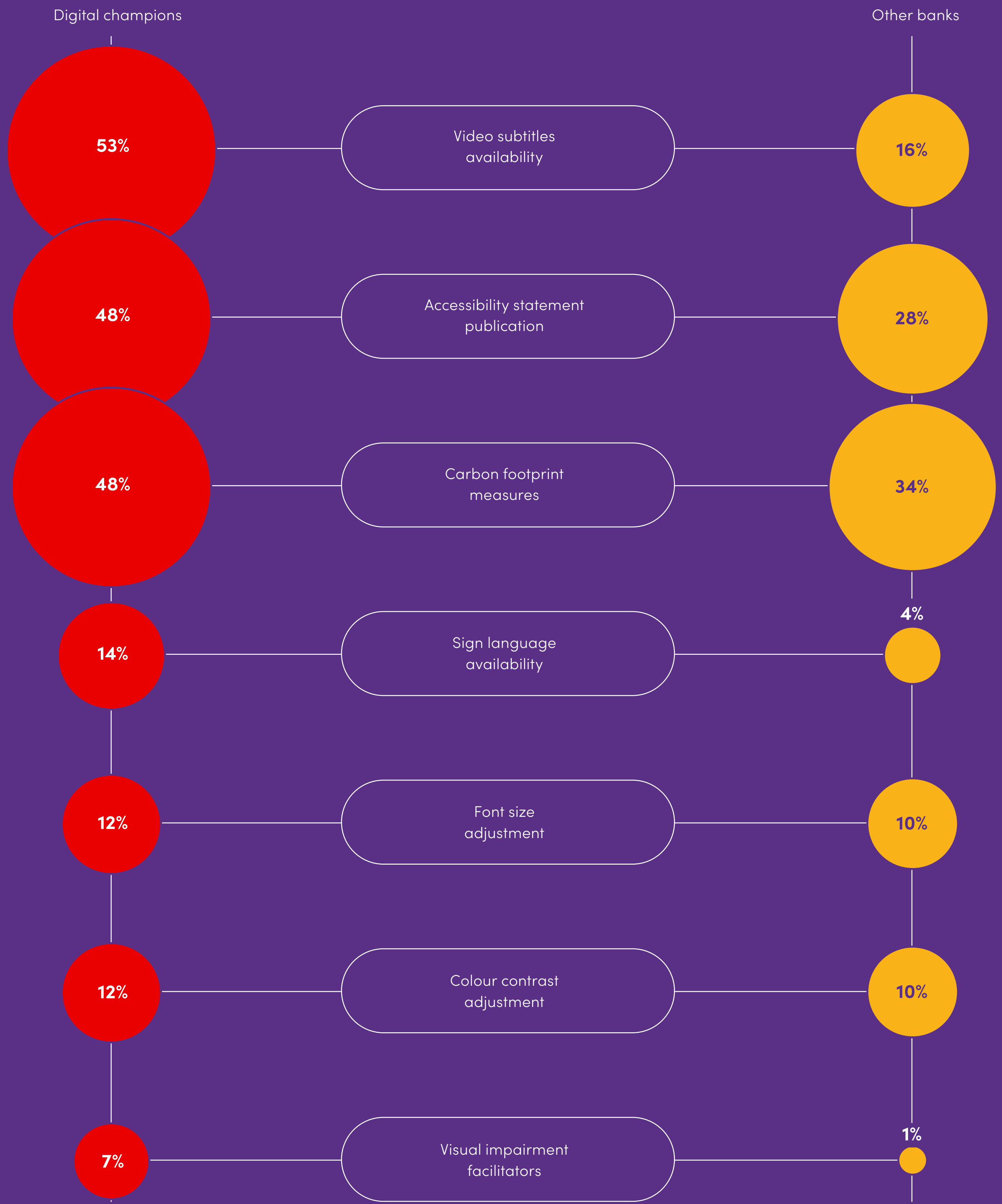
Digital Banking Maturity 2022, Deloitte



WHEN IT COMES TO ACCESSIBILITY, BANKS THAT ARE DIGITAL CHAMPIONS OFFER USEFUL FUNCTIONALITIES. HOWEVER, THERE IS STILL ROOM FOR IMPROVEMENT IF THEY ARE TO MEET ALL CUSTOMERS' NEEDS, AS WELL AS REGULATIONS

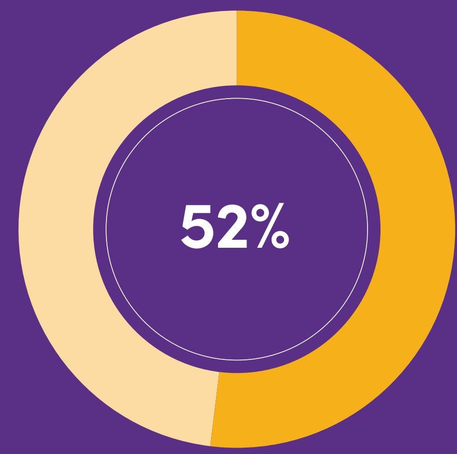
Percentage of accessibility and ESG functionalities offered by banks

Digital Banking Maturity 2022, Deloitte



PERHAPS UNSURPRISINGLY, NEARLY HALF OF 18-24-YEAR-OLD RESPONDENTS AND 49% OF 25-34-YEAR-OLD RESPONDENTS ARE HAPPY TO CONDUCT BANKING SERVICES THROUGH A TEXT-BASED MESSAGING SERVICE, EITHER WITH A BANK EMPLOYEE OR VIA AN AI-POWERED ASSISTANT

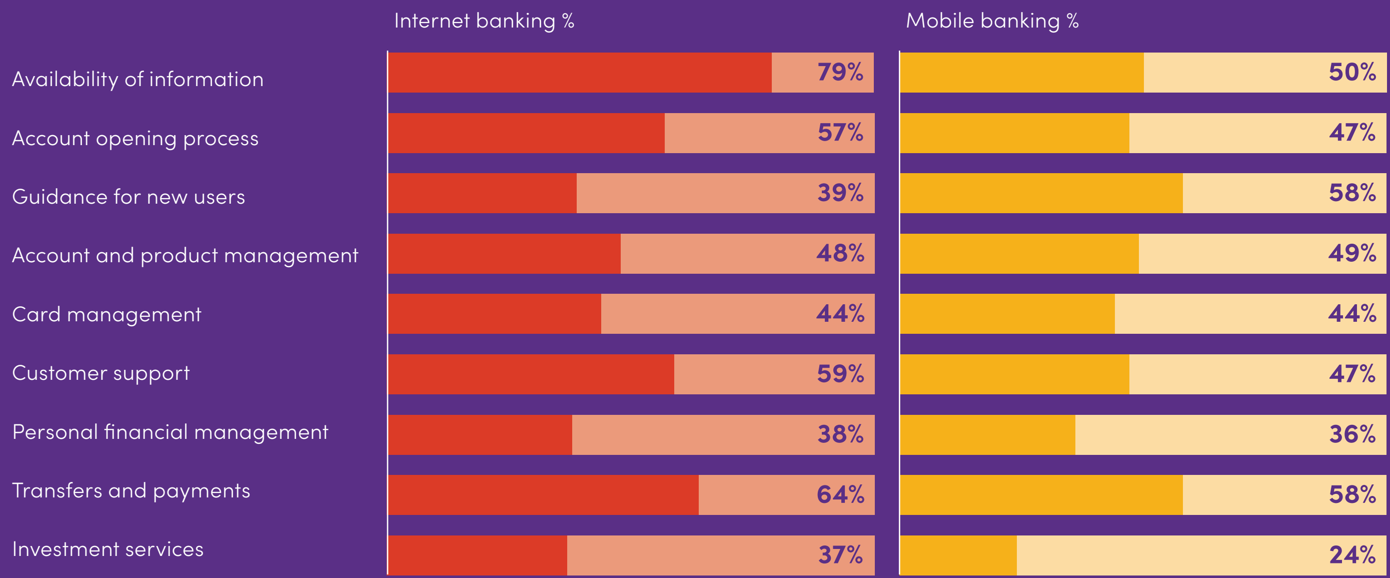
INDEED, MORE THAN HALF OF THOSE SURVEYED AGED OVER 45 WERE OPPOSED TO THE INTRODUCTION OF BANKING AI SERVICES



YouGov/IBM 2021

BUT, DESPITE THE MIXED FEELINGS AMONG THE OLDER DEMOGRAPHIC AROUND AI, MOBILE CHANNEL DIGITALISATION OFFERS ALL CUSTOMERS THE OPTIONS TO CONDUCT A VARIETY OF TRANSACTIONS VIA THEIR PHONE

Digital Banking Maturity 2022, Deloitte



This ties in with YouGov/IBM's survey finding that more than three-quarters of respondents have at least one bank account with an established high street bank

And, nearly 6 out of 10 of them use the bank's mobile app

YouGov/IBM 2021

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