Banking on the future

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About the authors

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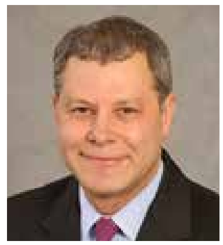
Brian is the national leader of KPMG LLP's (KPMG) Financial Services practice with 36 years of experience with the firm. He also leads KPMG's U.S. Banking and Capital Markets practice, which serves commercial banks, regional banks and community banks, investment banks and securities firms, and diversified financial companies. He has spent the majority of his career working with large, complex, multinational banking and other financial organizations. Brian has considerable experience and is well versed in the wide range of issues faced by financial services companies. He is a frequent speaker at financial services industry forums.



Judd Caplain

Judd is a principal who serves as KPMG's national Advisory industry leader for its banking and diversified financial sector. He is also a global lead partner for a top five bank. Judd's focus has been in commercial and investment banking, including in the areas of operational and finance transformation; strategy; regulatory and compliance; and process improvement and redesign in areas such as retail, wholesale and private banking, product control, credit cards, and payments.

Mitch Siegel

Mitch is the national Financial Services Strategy and Transformation leader for KPMG. He offers C-suite and board-level guidance across the financial services industry on business model disruption and operating model enablement intended to drive revenue growth, cost efficiency, and mitigation of enterprise risks.

Dan O'Keefe

Dan is a principal in KPMG's Strategy practice serving the financial services industry and leading our Banking Strategy practice. He specializes in defining market entry, digital, IT, and operations strategies for North American financial services clients looking to enter new markets, achieve revenue growth, improve customer experience, or reduce costs.

Foreword

“We are a technology company.”[1]

Lloyd Blankfein, chairman and CEO, The Goldman Sachs Group, Inc.

That brief but powerful sentence was uttered in 2015 by the leader of one of the most influential financial services companies in the world.

If nothing else, those words add urgency to the banking industry’s rapidly developing digital innovation initiatives.

In this report we take the position that meaningful change focused on producing tangible benefits can be realized if banks:

- Choose to adopt, partner or align with experience-driven digital interactions currently offered by financial technology (fintech) businesses
- Shorten their strategy cycle; think months, not years
- Get better at monitoring important signals of change that can inspire, inform, and help prioritize operational and strategic decisions in this disruptive environment
- Are fanatical about becoming agile organizations, both operationally and culturally
- Accept that there is not enough time or money to “rip and replace” core IT systems and instead consider alternative methods to freeze legacy code bases and wrap legacy information technology (IT) with digital services.

1 “Goldman in Ventureland,” *Bloomberg.com*, July 28, 2015

Better user experience? Leverage nonbanks

With digital start-ups accelerating the unbundling of the portfolio of services provided by the banks, "we are witnessing an unprecedented period of innovation and disruption in retail and commercial banking," says Brian Stephens, KPMG national line of business leader – Financial Services. "But the incumbents shouldn't lose sight of the abundant opportunities available to build, buy, or partner to get these capabilities."

"The increase in capital flowing into fintech," he says, "reinforces the idea that traditional banks must continue to explore synergies with fintech ideas and talent."

Increasingly, executives at large and regional banks either already have or are considering partnering, buying, or even building fintech solutions to keep pace. (**see BBVA case study on page 4**)

But choosing a partner may simply be a key first step. Banks seeking to serve customers in a faster and more transparent fashion may also consider sharing application programming interfaces (APIs) to their proprietary software code, thereby increasing the chances for quicker innovation. BBVA Compass, Bank of America, Capital One, and Citibank already have dipped their toes in these waters.[2]

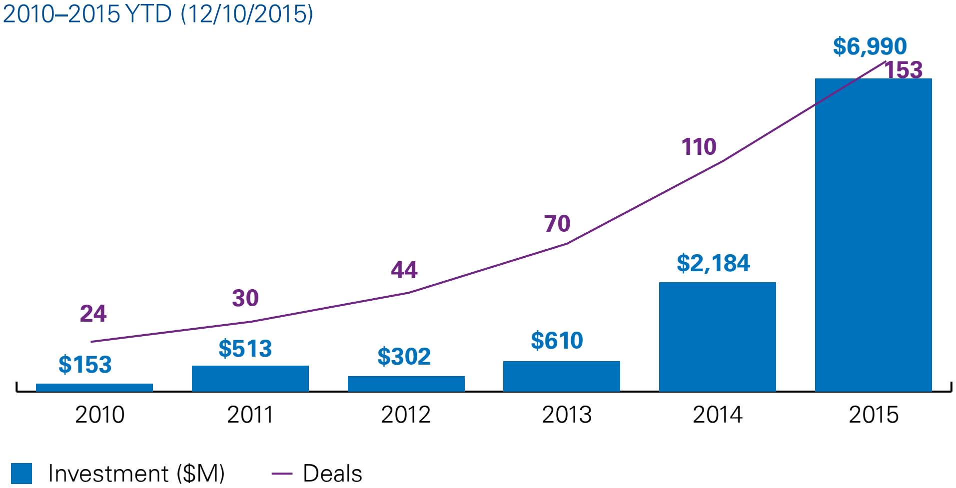
Bank of America's Chief Executive Brian Moynihan, during a November 2015 call with bank analysts, said that if traditional banks were to stumble in their fintech transition, "it may allow part of our industry to be forever taken away from us."[3] Still, we believe predictions that banks are on the cusp of obliteration are off-target. In our view, both parties need each other: Fintech needs banks' scale and their hard-earned experience in working with regulators, while banks need fintech's fresh talent and tech savvy.

Consider these statements: Blythe Masters, a former JP Morgan executive and now CEO of investment technology start-up Digital Asset Holdings: "Anyone who imagines that as a result of the advent of new technology, we will see a world where incumbent financial institutions…will be decimated and completely removed from the picture overnight is just naive and wrong."[4]

Chris Larsen, cofounder of Prosper Marketplace and CEO of money-transfer start-up Ripple, adds: "You see a lot of bluster around 'we're going to kill the banks, disrupt the banks,' but most of that is nonsense."[5]

Digital banking global yearly financing history

2010–2015 YTD (12/10/2015)



Source: CB Insights, 2016 – used with permission

[2] "Fintech Glasnost: Why U.S. Banks Are Opening Up APIs to Outsiders," *American Banker*, July 9, 2015

[3] "As More Pay by Smartphone, Banks Scramble to Keep Up," *New York Times*, January 18, 2016

[4] "Will Fintech Upstarts Do To Banks What Uber Has Done to Taxis – Or Will Banks Win?" *Forbes*, October 20, 2015

[5] Ibid

BBVA Compass – Progressive partnering: A case study

Manolo Sánchez

Photo: BBVA Compass

"We see fintech companies more as opportunities than as competition," BBVA Compass Chairman and CEO Manolo Sánchez says of nonbank disruptors in the financial industry.

BBVA Compass, a Sunbelt-based subsidiary of the Spanish multinational BBVA, has a reputation for bold moves. It is working with Dwolla, a real-time digital payments network, and with BlackRock's digital ("robo") investment service, FutureAdvisor. In 2014, its parent company, BBVA, through BBVA Compass, bought online bank Simple, and BBVA also recently invested a nearly 30 percent stake in Atom, the United Kingdom's first mobile-only bank, expected to launch in the near future. BBVA also recently announced an increase in its fintech venture fund to $250 million and a collaboration with Propel Venture Partners, which will manage the investment independently.

For BBVA Compass, fintech developments are providing a classroom environment. By staying out of the day-to-day operations of Simple, Sánchez says he can "observe from a distance and learn."

He says there is "a sense of urgency" in his organization because the "drivers affecting the industry are moving extremely fast, and consumers' habits are evolving at an incredibly quick pace."

Real-time payments through Dwolla, he says, are a prime example of addressing the oft-cited "disconnect" between customers and banks, since most banks run transactions in batches at the end of the day, rather than immediately. "When you really think about batch processing," he says, "is there anything in the world today that works like that? Do you think anyone would find it acceptable if e-mails were held for a full day and then released? The infrastructure in banking is literally from another century."

Banking's exponential evolution, which may yet be in its beginning stages, brought BBVA to the realization that "we had to rewrite the bank for this era," Sánchez said, despite the fear of change that challenges any organization or industry in the throes of transformation. "We learned we needed to create a conviction that the time had come to adapt, that we had to avoid resistance. We saw that we could take advantage of new opportunities for serving customers in the ways they want to be served."

When given the chance to align with fintech start-ups, Sánchez said the bank asked itself a fundamental question: "Do we want to be a company that is embracing change, or do we want to be one that is thinking that we should be in a fortress, trying to stay away from the fire?"

Shorten the strategy cycle

Remember three- and five-year strategic plans in banking? It is time to forget them.

"Technologies that are now being used to carry out transactions or that are the foundation of a service or a product are quickly shrinking what we used to consider standard strategy cycles" says Judd Caplain, KPMG's national Advisory industry leader, Banking and Diversified Financials. "Few, if any, banks are thinking in terms of three-year strategic plans right now."

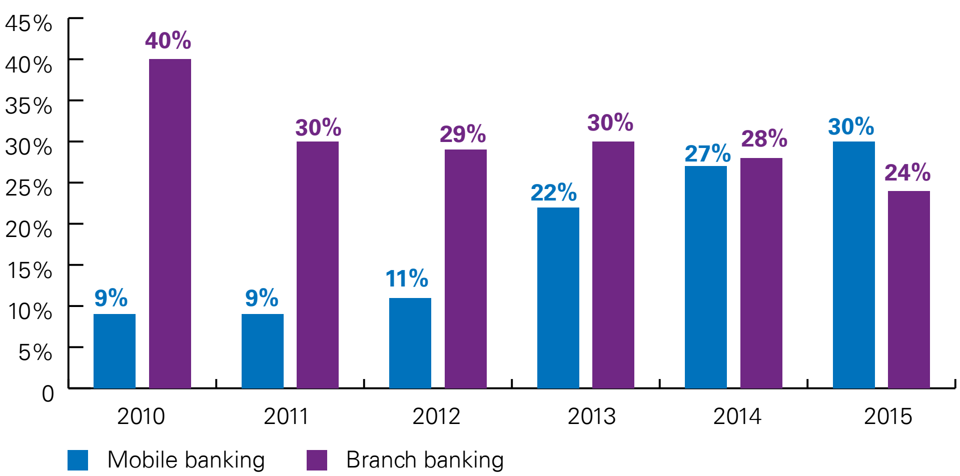
Bank tech start-ups that are relentlessly unbundling products and services that formed the core of traditional banking for generations are forcing the contraction of the strategy cycle. That shrinking of the cycle requires bold, but well thought-out responses by banks. Since not all banks can provide all products and services to all customers, executive teams must carefully choose their core customer segments and create a strategy that fits the needs of the businesses and consumers in those segments.

"Strategic planning needs to move higher on the board and management committee agenda and should be reviewed monthly or even on an ongoing basis to monitor the signals of change and make course corrections to the prioritization of strategic initiatives," says Mitchell Siegel, KPMG's Financial Services Strategy practice leader.

A December 2015 *CB Insights* study revealed data that funding for digital banking start-ups globally reached nearly $7 billion in 2015, more than triple that of 2014's record-breaking figure.[6] A prime strategy decision point for many incumbents could be the future or the extent of their branch-banking system. In 2015, for the first time ever, more people used mobile banking applications than they did bank branches, according to a recent banking research report issued in January 2016.[7]

"Whether the bank is faced with challenges in mobile or robo-advisory or P2P lending, banking teams will need to take a deep, holistic view of their organization's strategy but still be able to move quickly or make certain changes when new technologies force the issue," says Daniel O'Keefe, KPMG's Banking Strategy practice leader. "Otherwise, it could be death by a thousand cuts."

Mobile banking exceeds branch banking



Source: GA Javelin LLC, 2015 – used with permission

[6] "Funding to Digital Banking Startups Has Jumped More Than 10X Since 2010," *CB Insights.com*, December 15, 2015

[7] "Mobile Banking Outpaces Branch Banking For First Time in 2015," *Javelin Strategy & Research/Greenwich Associates LLC*, January 12, 2016

Mine market signals for impending change

Similar to a bank's management team and board thinking in terms of a shorter strategy cycle, we suggest banks dedicate more time and resources to picking up emerging signals of potential market disruptions. By mining those signals and acting on the intelligence, banks can create strategies to thrive in this fluid financial services environment.

"These signals of change are evident in many areas," says Stephens. "They are bubbling up in attitudes and behaviors of certain demographic segments in the way people are embracing—or not embracing—technologies, in where investors are placing their bets, and in how regulators are likely to act."

The idea behind mining signals, according to Siegel, is to have the best information at the best time to pick your spots where growth is most likely.

"Assess your bank's value chain by reconciling your choices for growth against the signals you are continuously mining. That kind of information will help you decide whether you should build, buy, or partner to gain a new capability or perhaps if you should invest or divest in a segment of your business."

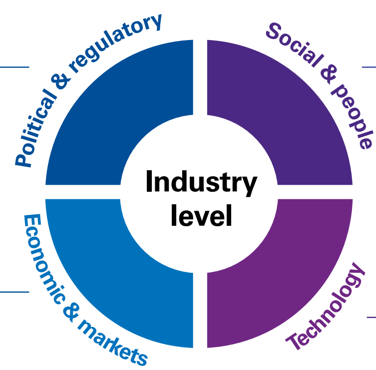
Because the pace of change can often outrun a business's strategy, mining emerging signals is essential in helping the business adjust its strategic plan before it hits a threshold of change. If change gets that far, repositioning a business may be difficult.

Mining emerging signals is not meant to displace traditional trend and market intelligence but instead complement those methods by highlighting unknown or unexpected factors influencing customer expectations and behaviors.

By combining the traditional methods with signal mining methods, banks could extract valuable insights into emerging business models being deployed by would-be competitors. But are bankers really listening?

In *Bye Bye Banks?*, a recent book that suggests there will be deep change in banking's near future, a survey of 110 senior banking executives discovered half of the respondents have never heard of a series of widely popular banking/fintech businesses. One of the coauthors, James Haycock, concluded: "I think it's indicative of a sense of complacency an incumbent business can have. These new businesses arrive very quickly. Until they're actually stealing significant market share and revenue, they may not be on the radar."

Questions to ask
when reviewing drivers and disruptive **forces of change**



Tech giants
What are tech giants investing in? How could it be a game changer?

Regulatory trends
What are key regulatory developments?

Start-ups & VCs
What are start-ups working on?
Who is funding them and what business models are they intent on disrupting?

People trends: customer & employee
What are changing demographics and behavior? How are they accelerating technology disruption?

Digital disruptors
What are key technology innovations?
How is technology changing how people behave?

Enhance agility: Turn on a dime

"They all want to eat our lunch."[8]

Jamie Dimon, chairman and CEO, JPMorgan Chase

Fintechs may have a voracious appetite, but banking incumbents are not standing still. In fact, they are reacting in a positive way to the fintech threat. They are making significant venture capital investments in fintechs, and they are creating important alliances in the tech world in the pursuit of better customer connectivity and revenue growth.

Still, a fundamental question to consider is whether banks are adapting fast enough to avoid an appreciable erosion of their franchise to the newcomers.

The answer, as we see it, is that although many banks have made advances, such as in the use of analytic tools for quicker decision-making and switching from a "product-first" to a "customer-first" emphasis, a significant obstacle to improvement for many is their lumbering pace of change.

If banks expect to attack issues such as trust and relevance to millennials, they will need to confront the agility question: Can they quickly adapt to manage the exponential changes roiling the industry?

Legitimately, bankers will point out that a reason for the slower pace of change is that they, unlike their new competition, have had to deal with the avalanche of regulation. Also, unlike fintechs, banks are carrying enormous technical debt in their legacy IT systems built up by decades of add-ons.

It is also accurate to suggest banks often lack agility due to a reputation for a resistance to change.

Inside many banks, for example, there may be reluctance to confront issues of compensation structures because individuals are managing units or divisions with profit and loss responsibilities (P&L) and with "turf" they may be trying to protect. Much of that behavior has been traditionally driven by compensation structures that are in place. Some new methods of delivering new products and services to customers may necessarily, at least in the short term, have a negative impact on a bank division's P&L. The question banks will need to address is whether senior management will accept that pain in the period of restructuring without penalizing managers who are being asked to change long-standing processes and procedures.

A former Barclays director, Lee Sankey, who now operates Door, a business innovation consultancy, says, "If you're a group managing director responsible for a P&L, it's understandable you're not going to innovate or disrupt in a way that damages your P&L."[9]

Banks, for example, must be willing to experiment more often by creating such structures as innovation labs, where the purpose is to learn instead of create an immediate return on investment. (**See BNY Mellon case study on page 8**)

Banks could mimic independent VC businesses, which have earned a reputation for learning to take chances on small ideas, but be willing to accept that many will fail. But by getting in and, if necessary, out quickly, banks can find powerful ways to rapidly test out ideas until they embrace those that bring real value in a hurry.

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[8] "Goldman in Ventureland," *Bloomberg.com,* July 28, 2015

[9] "Banks Need to Shift Focus from Money to Value," *Wired.com UK,* July 1, 2014

Many larger banks already have resources to increase funding for their innovation initiatives. But the difficulty very often in banks is that they are driven by a quarter-by-quarter profit mentality that can stifle creativity, investment, and innovative risk-taking.

Agility, which is closely tied to risk-taking, must be balanced against prudence, since regulators will not tolerate instances where bad behavior creeps in.

Interestingly, for all of the bad press banks receive for being stodgy and slow on the uptake when it comes to the ideas being launched by fintechs, banks also have a long history of creating new products and edgy ideas. New York Federal Reserve Bank President William Dudley recently said that "risk-takers are drawn to finance like they are drawn to Formula One racing."[10] Such risk-taking is important for banks to develop ways to improve client service and create innovative products, but risks must be governed equally by an ingrained culture that creates boundaries.

It would benefit the banking business now if the nerve displayed in risk-taking described by Dudley were deployed in an industry-wide improvement of agility.

Case study

BNY Mellon's cultural revolution

In a recent *American Banker* article, Bank of New York Mellon's annual innovation contest was profiled. While the focus was on employees developing ''the next big thing" for the bank, an interesting element in the article was the person who heads the lab and the contest, Virun Rampersad, was referred to as a "chief culture officer."

Rampersad's actual title, the report noted, is head of global innovation.

BNY Mellon's "Accelerate, Collaborate, and Execute" initial competition received 468 ideas from 1,000 employees. The winners this year were awarded $100,000 to split among four team members, and the idea has entered the bank's incubation program. Other finalists were given an executive committee sponsor and funding to help further their ideas for possible incubation in the future.

Bank president Karen Peetz was quoted as saying that the decision to nurture innovation was championed by board member Nicholas Donofrio, a retired IBM executive, who led innovation and technology at that iconic company.

Peetz was also quoted saying: "No one knows your organization better than your employees…getting them engaged in constant improvement becomes part of your fabric—it is the only way to get continuously better."

Source: "Innovation Is More of a Cultural Revolution for Banks Like BNY Mellon," *American Banker*, November 2, 2015

[10] "As Regulators Focus on Culture, Wall Street Struggles to Define It," *The Wall Street Journal*, February 1, 2015

"Freeze and wrap": Becoming digital to the core

Since disruption is the new reality, managing IT challenges requires a more proactive approach. "The answers of the past—large-scale, multiyear technology replacements—take too long, fail too often, and are constantly reprioritized due to their size, scale, and complexity of banks' systems," KPMG's Siegel says. "Rather, we believe it best to shift toward a 'freeze and wrap' approach. Banks must be digital to the core."

While we recognize that some technology must be replaced either for performance or regulatory reasons, we also believe in the emergence of parallel and multiple efforts to freeze the code base of legacy technology and reduce its capabilities to simple accounting.

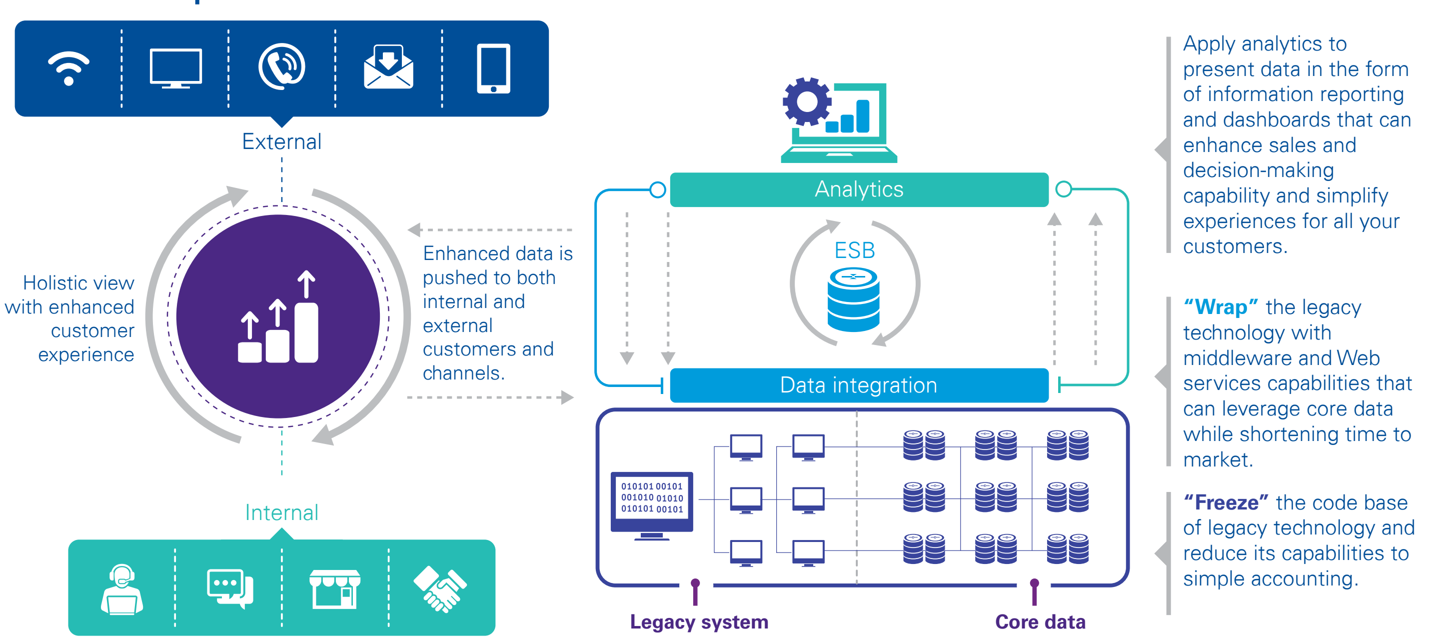
In our view, a strong viable option is to stop adding code onto legacy technology that banks know won't sustain their business aspirations. "Rather," Siegel adds, "it would be beneficial to 'wrap' the legacy technology with middleware and web services capabilities that can leverage core data while shortening time to market and enhancing the data you push to both internal and external customers and channels."

Siegel suggests banks focus on the "digital overlay" of the technology, "applying analytics to present data in dashboards that can enhance sales and decision-making capability and simplify experiences for all your customers."

Do this in a way that adopts pieces of agile methodology with a focus on combining multifunctional teams (product, operations, IT, user- and customer-experience developers) in "delivery cells" or "product pods" that can drive expedited product functionality through a customer-experience value chain.

We have seen this strategy reduce cycle times to weeks and months rather than years and we would debate that it is also an effective way to align revenue and market-share enhancement goals to budget spends. In our mind, that is a potential value proposition that cannot be ignored or even delayed.

Freeze and wrap



Getting started: How KPMG can help

With so much information surrounding banks about the tumultuous industry environment, it is understandable that some bank management teams and boards might find it difficult to make sense of the information and determine how to act on it in a progressive manner.

Getting started on progress rests on an ability to recognize opportunities while possessing the facility, talent, and determination to act. Inertia in this environment will be toxic; standing still is not an option.

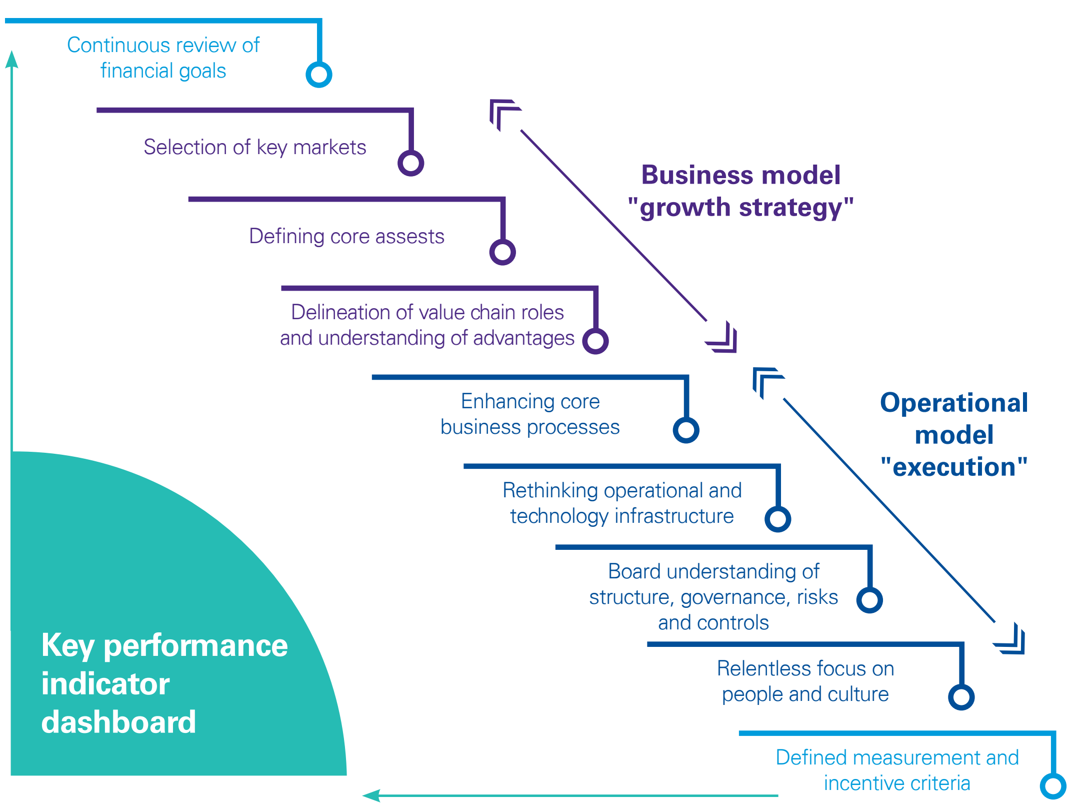
Our focus in this report has been to suggest that banks and fintech newcomers need each other to build a better experience for users so that all stay in a winning path. Creating benefits that are tangible will serve as the measuring stick for success. Ideas are terrific. Real uses of those ideas to help businesses and retail clients get better and faster results from their banks are even better.

When banks decide they must partner or align, they must be prepared to seize the momentum, and then they must continuously reassess how their alliances and the products and services they create are benefiting customers. The pace of reassessment will no doubt be a difficult change in ways of working, thinking, and interacting with customers for many established, incumbent institutions.

This change will mean reading the tea leaves in an entirely new way for many in the industry, and it will mean not only learning to pivot faster but also to be willing to make reassess decisions even faster.

Come speak to us about our ideas that we believe can help those who are ***banking on the future*** in order make progress.

Nine levers of value framework



- KPMG uses the "Nine levers of value" framework to define and update their competitive strategies.
- Adjusting skills and capabilities necessary to realize new strategies is one of the most important and difficult aspects of successful strategy execution.
  - Gaining new skills and capabilities (e.g., innovation, technology, data analytics, trusted advise)
  - Scaling back existing skills and capabilities that are losing relevance

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