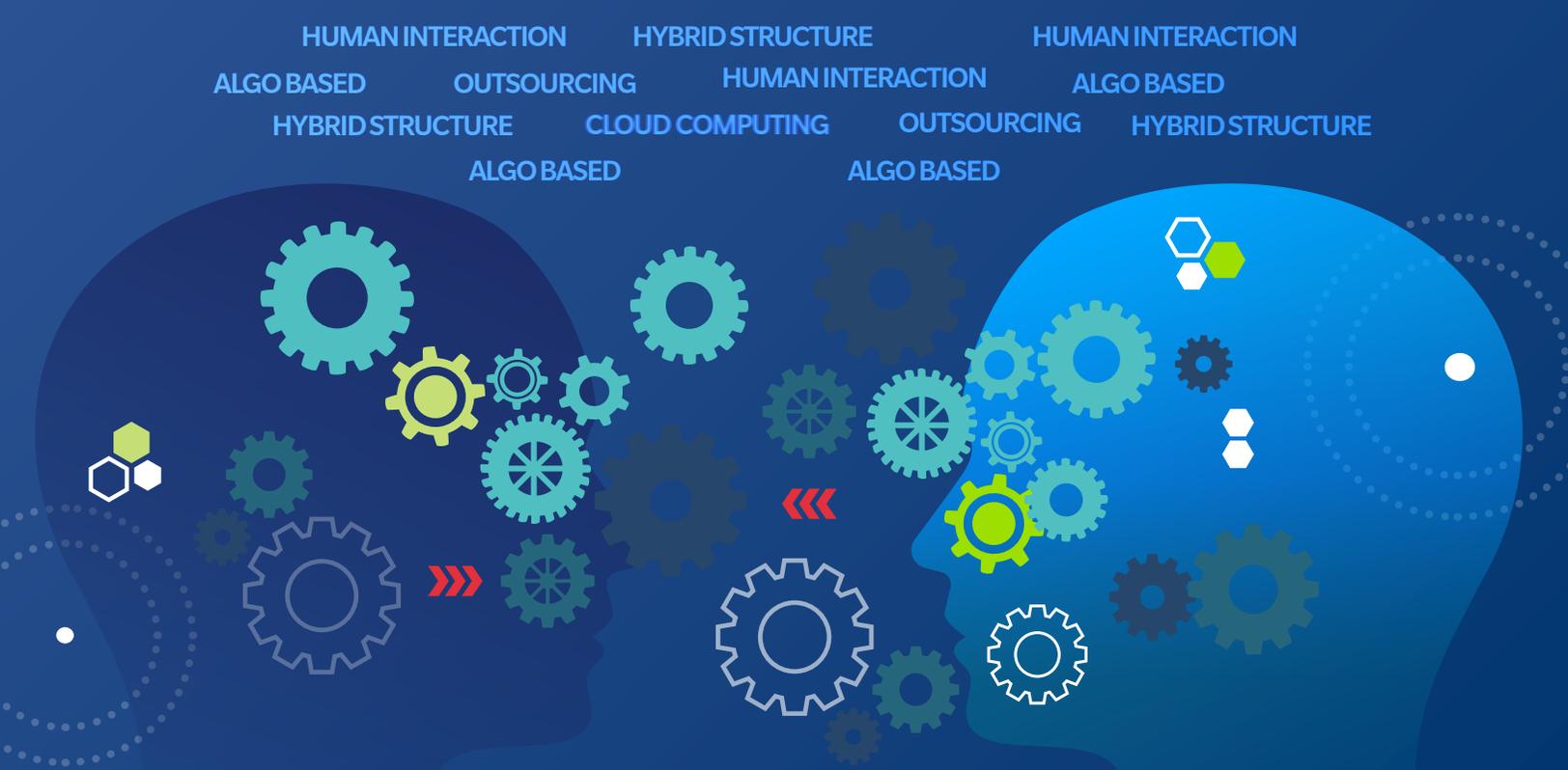


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Sharpening the Competitive Edge: A Tier 2 / Tier 3 Bank Perspective



IBS intelligence

Contents

01	BANKING SECTOR - EUROPE A PERFORMANCE OVERVIEW	3
02	TIER-2 / TIER-3 BANKS VS. TIER-1 BANKS AN INDUSTRY PERSPECTIVE	3
03	TECHNOLOGY TIER-2/TIER-3 BANKS	4
04	CHALLENGER BANKS' PERSPECTIVE AN OVERVIEW	6
05	EXCELLING AT CUSTOMER EXPERIENCE TIER 2 & TIER 3 BANK	7
06	TECHNOLOGY DRIVEN CRITICAL SUCCESS FACTORS	9
07	CONCLUSION	10



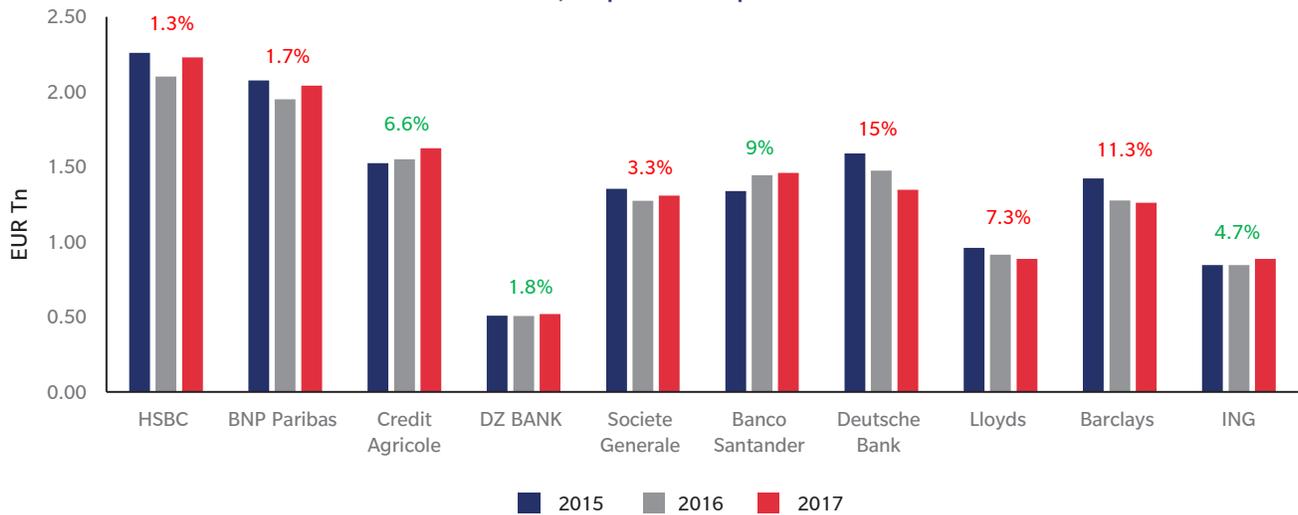
This document has been written by IBS Intelligence in collaboration with ERI, a major provider of IT solutions to the international private banking/wealth management space, as part of its contribution to the debate on the future of the industry.

01 BANKING SECTOR - EUROPE | A PERFORMANCE OVERVIEW

The Euro region experienced a positive growth of 2.4% in 2017. However, the following two metrics indicate the banking industry did not perform well compared to 2015 and 2016. First, the overall asset size for all the European banks in 2017 is about US\$ 51.67 Tn which is -1.2% since 2015 (US\$ 52.29.1 Tn). Second, the total assets held by the top 10 European banks contracted by an average of -1.6% between 2015 and 2017.

From an overall bank profitability perspective, in 2017, the ROE for European banks was of the order of 5.6%. In the most significant EU economies such as the Netherlands, Italy, France, Germany, and Spain the average ROE in 2017 reached 8.8%. However, it has reduced by 50% over a decade, after reaching a peak of ~25% in 2013.

Total Assets | Top 10 European Banks



A quick comparative of the growth of the top-10 banks in Europe, as against the total banking industry reveals 3 interesting insights. First, while the tier-1 banks have not performed well, the tier-2 / tier-3 banks along with challenger banks have balanced the total asset size for the region. Secondly the banking sector in this region has been exploring multiple ways to increase profitability and finally the tier-2 / tier-3 banks look for opportunities to differentiate themselves from the tier-1 banks.

02 TIER-2 / TIER-3 BANKS VS. TIER-1 BANKS | AN INDUSTRY PERSPECTIVE



A key takeaway of the study is the outperformance of tier-2 / tier-3 banks as compared to their tier-1 competitors. The contributors for this differentiation could be viewed from 3 dimensions: People, process and products.

People (Customer Servicing): Typically, customer expectations from tier-2 / tier-3 banks are diverse. While there is one section of of the customer base who prefer banking services with a personal touch, there are other customers to whom all that matters is banking through digital platforms. Customer expectation from a tier-1 bank, in most geographies, is banking with ease.

These tier-2 / tier-3 banks have done a good job in establishing a personal connection with customers. Some of them have adopted a community banking approach, targeting their customers by grouping them based on their postal code to understand them better. Hence, from a customer standpoint, tier-2 / tier-3 banks have a clear advantage regarding building and servicing a stronger customer base.

Process (Agility): Tier-1 banks with multiple entities and operations typically involve interdependent operations and processes. Agility refers to the swiftness with which a change can be implemented. This is one of the strengths or differentiators which are inherent to tier-2 / tier-3 banks. This becomes a critical aspect for building the change management strategy, which is more straight-forward for these banks when compared to tier-1 banks.

Product Strategy (Simplicity): A tier-1 bank typically offers about 100-150 principle products and has an average of 6-8 variants for each product. However, a tier-2 / tier-3 bank has about 30-35 products with an average of 3-4 variants for each product. This indicates that the number of variants offered by these banks is ~50% lesser than the tier-1 banks. Too many choices are bound to confuse the customer without proper guidance from a relationship manager. This is where the strength of tier-2 / tier-3 banks lies - relative simplicity regarding product strategy.

03 TECHNOLOGY TIER-2/TIER-3 BANKS

Customer expectations and behaviour related to use of financial services have changed dramatically and is continuously evolving. Customers demand easy access, fast service, and intuitive interfaces. For financial service providers, this often means an implicit requirement to provide 24/7 access to financial services and going beyond the traditional physical branches with an emphasis on digitisation.

We evaluate our digital strategy from the point of view of what customer problem are we solving rather than looking at it as cool feature to have.

- Deepak Sharma, Chief Digital Officer, Kotak Mahindra Bank



1

The average occurrence of the word "digital" in the annual reports of tier 2 / tier 3 banks was anywhere between 30-50 times.

2

The number of recruitment adverts on IT and engineering roles at these banks across the EU in Q1 2018 was 11.4 times higher than in Q1 2015.

3

Over two-thirds of UK adults used online banking and four in ten used mobile banking via an app on smartphone or tablet in 2017.

Technological advancement is directly proportional to profitability. The tier 2/ tier 3 banks who showcased significant focus on digitalization and technological advancement, had a revenue growth at a CAGR of 3.5% between 2011 and 2017. Furthermore, their costs grew at a CAGR 1.6%. These banks were able to increase their profitability, and one of the key reasons was their focus on technology. With technology and innovation as a part their core strategy, tier-2 & tier-3 banks are focusing towards optimising their cost bases, thereby increasing their profitability. Reevaluating its branch network is one of the initiatives in this regard. The trends indicate an inclination towards a significant reduction in the branch network and moves towards digital channels rather than just striking a balance between branch footprint and digital channels. To avoid falling behind, the tier-2 / tier-3 banks are trying to adopt technology as an essential ally and optimise their day to day operations. During the short-term, initial investment will drive up costs and in the long term these banks are attempting to optimise the number of employees in back-office and support functions with the help of new age technology.

The image of the IT department in a bank is changing and it is no longer seen as cost center. The CIOs and CTOs are treated as being among key stakeholders to business enablement supported by digitisation

- Consultant - IT, Tier-2 Bank, Kuwait

Following are some of the real-time industry examples of how technology is being leveraged to drive down the operational costs:

Industry Example #1 | Use of Automation to digitize and automate client payroll processing



Initial Context: A mid-size bank in Middle East, was looking at optimising its bulk payments process. The majority of their data was in non-digitized, inconsistent physical formats. This along with multiple handoffs and approvals caused process delays and increased TATs.

Solution & Benefit: The bank digitized its data and shifted the entire process workload to automation bots. Client's turnaround time was reduced by 97%. The rate of automation increased by 200% in less than three months, with bots servicing 99% of total request volume. ~6-8 Full Time equivalents performing repetitive tasks could focus on serving customers rather than back-office processes.

Industry Example #2 | Automation to enhance customer experience & process efficiencies



Initial Context: A mid-size bank in Columbia, wanted to enhance its banking customer experiences & increase operational efficiency. The bank wanted to develop a virtual workforce that combined human, robotic, cognitive, & analytic capabilities.

Solution & Benefit: Bank implemented hundreds of bots that allowed the bank to improve their front and back office capabilities. Since the introduction of digital workforce capabilities, the bank has saved more than 127K hours of time in their branches. The bank recovered its investment with a 1300% ROI within the first year. The automation helped create new revenue streams of around US\$ 7 Mn.

Industry Example #3 |
Cognitive Automation /
Machine Learning Enabled
AML Investigations



Initial Context: AML investigation involved internal and external systems – Mantas, RRS, Internal KYC, LexisNexis, Google and Hogan (CBS). For each case of AML investigation, about 45-50 files were generated; 340 seconds per case. Iterative investigations resulted from data inaccuracies due to manual interventions

Solution & Benefit: Automation resulted in generation of 4-5 reports for AML investigations per case. Overall audit handling reduced from 340 seconds to 86 seconds per case. ~75% faster case processing. Higher productivity delivering benefits equalling 12 FTEs

04 CHALLENGER BANKS' PERSPECTIVE | AN OVERVIEW

Interestingly, the top 25 challenger banks across the globe have more than 1 million users. Venture Capitalists have invested ~\$1.5 billion in challenger banks in the first half of 2019, which is a 15% increase from the same period in 2018. Undoubtedly, it is one of the fastest-growing sectors among FinTechs.

Technology | Inherent Advantages

A challenger bank by nature is a FinTech company natively built for offering financial services. However, challenger banks have their banking infrastructure on the cloud, offering competitive banking services. Due to its technology-driven nature challenger banks, from an operational aspect, have a few inherent advantages as discussed below:

The Back-Office | The back office or the core banking solution is the backbone of any bank. For stable operations, a robust core banking solution is a must. While the conventional banks deploy an on-premise core banking solution, the challenger banks deploy it on a cloud infrastructure with APIs exposed to the internal and external world. Gaining support on cloud can drastically reduce the operational cost. It also allows the challenger banks to focus on obtaining an efficient use of resources and processes, and enables a flexible approach when considering IT and associated infrastructure.

The Middle & Front Office | With the APIs exposed to the internal and external world from the core banking solution, the task of integrating the surrounding systems and third-party systems becomes easier for the challenger banks. This can be well explained with an example wherein, we are integrating with a RegTech solution or Optical Character Recognition (OCR) solutions or more complex solutions such as, Enterprise Fraud and Transaction Monitoring solution. The icing on the cake is when the core banking system is also made available on the cloud. From a business strategy perspective, if the challenger bank has to offer a new service, the time to market is drastically reduced from days to hours.

Challenger banks will continue to pose a challenge for traditional banks across tiers in the upcoming years. However, they will also look forward to collaborate with traditional banks to specialize and create a niche

– Board Member, Leading Challenger Bank, Germany

Challenger banks have always been exploring ways to leverage technology. Below is a summary of top 3 exciting avenues.

Crowd Contribution | Challenger banks such as Fidor Bank have built a community which includes its banking customer, industry experts, and freelance developers. The community provides regular feedback for enhancing the capabilities and process, which is then incorporated into the system. Further, it has exposed Software Development Kits (SDKs) for its community which the developers can use to build a new capability or enhance the existing functionality. The technology arm of the bank then evaluates the enhancements and includes them as part of the live solution.

Collaboration | API/Open Banking technology driven by PSD2 guidelines such as account aggregation and data sharing have acted as catalysts for conventional as well as challenger banks to collaborate. An advantage here is that two or more challenger banks can collaborate faster than traditional banks by the very nature of their organisation and processes.

Best of Breed Solution | With cloud-first strategy and API banking technology as their modus operandi, the challenger banks have significant freedom to implement best of breed solutions in comparison with their conventional banking counterparts. This way, challenger banks can operate with substantial flexibility and leave no room for compromise in providing a consistent and seamless customer experience.

05 EXCELLING AT CUSTOMER EXPERIENCE | TIER 2 & TIER 3 BANKS

Before understanding what the tier-2 / tier-3 banks are doing to excel at customer experience, it is crucial to understand the challenges faced by banks in this category. Bill Gates famously quoted, “The world needs banking, it does not need banks.” This simple statement which sums up the strategic principle that many of the banks in the industry have not been able to achieve. Banks have long focused on getting their product strategy right, and hence the inclination towards understanding the customer needs and aligning its business, and IT strategy has tended to be given a lower priority. The impact of this is evident in the incumbent banks’ struggle to provide consistent customer experience and in turn, retaining their customer base.

Key Challenges

Customers’ Mindshare | According to the European Banking Association, the number of branches in Europe has reduced by 21% between 2007 and 2017, or by almost ~50,000. Further, the statistics also state that more than 50% of EU individuals used digital channels (internet and mobile banking) for banking services in 2017. In 2008 digital channel users were just 29%. With such significant growth in digital penetration, the customer receives digital marketing campaigns in large numbers. Hence, maintaining the customer’s mindshare is a crucial challenge.

Customer Expectations | The EU population is somewhat diverse. While 60% of the population lies in the bracket of 15 to 65 years of age, there is only 15% of the population who are above the age of 65 years. The banks need to cater to the diversified needs of the customers across different segments. Hence, understanding the expectations of the customers and converting them into attractive experiences remains a challenge.

Market Pressure | Compared to the large players in the market, the small and mid-sized players have limited scope to invest in having a full-time in-house or outsourced technology arm associated with banks. For example, Citi Ventures (of Citi group) has invested in three independent technology companies - Pindrop, vArmour, and Tanium just to enhance its cybersecurity. Such privileges cannot be afforded by the tier-2 / tier-3 banks.

How are Banks Managing

Omnichannel Presence | Tier 2 and tier 3 banks have responded to the demand for digitalization by exposing the financial services through multiple channels for their customers apart from internet and mobile banking. For example, tablet banking, kiosks, and wearable devices such as smartwatches. However, the approach, “One size fit all” doesn’t work in this case. Banks have been brilliant at choosing a channel for exposure of their services and are backed by strong rationale.

New Age Technologies | Going a step further, tier-2 / tier-3 banks are exploring machine learning and automation for servicing their customers. Some of the most popular use cases around this are associated with deploying conversational & transactional bots and/or digital onboarding using automation. While implementing a new age technology is the imperative, the technology implication is the need to have/build a robust and flexible base, i.e., core banking system, such that it can provide a strong base to accommodate the new age technologies.

An interesting observation that requires a special mention is that, with the implementation of new-age technologies, the financial institutions are consciously transferring some of the front-office roles to the customer. It also acts as one of the best ways to empower the customer. For example, let us consider a simple scenario of digital on-boarding for a loan application. Typically, a customer would fill up an online form, click the images of all the required proof and submits the application. In the front-office, it is the support systems such as an OCR software which recognizes the images, extracts data specific to the fields and an algorithm that makes an entry in the middle-office layer for further processing of creditworthiness, etc.

Following are some similar examples of solutions implemented by financial institutions across geographies:

Industry Example #4 | Automation to power a fully automated digital lending platform



Initial Context: A German based mid-sized lending services provider wanted to create an entirely online automated credit platform for SMEs. They built a proprietary credit platform but needed automation support to make online loan application and processing fast

Solution & Benefit: Built and deployed hundreds of robots and supporting APIs to automatically extract data from multiple sources including customer submissions. The solution then integrates all this data & transforms it so that it can be used by the lending platform’s credit assessment algorithm. Now the platform is able to provide a business credit offer (ranging from US\$ 11k to US\$ 280k) to a customer within minutes of receiving their application online. A full return on investment in under a year.

Industry Example #5 | Digital Onboarding to improve customer experience

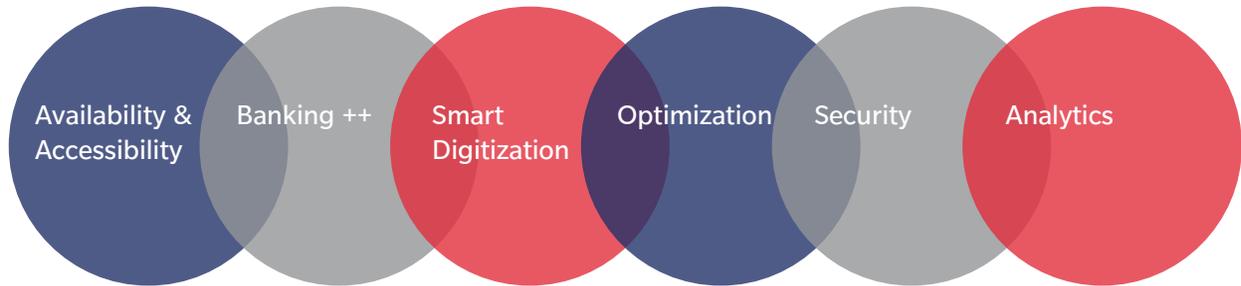


Initial Context: A tier 3 bank based out of South America specialized in credit card services had launched a new hybrid credit card and transport payment card, which had a huge market. Current credit card application processing was highly manual

Solution & Benefit: Bank automated end to end credit card application process. Once the customer’s application was approved, the bank was able to print & emboss their card on the spot. Customers were able to walk out with a new payment card in as little as 10-15 minutes. Bank was able to cut the time taken to issue payment cards from three weeks to under 15 minutes.

06 TECHNOLOGY DRIVEN CRITICAL SUCCESS FACTORS

In summary, the tier-2 / tier-3 banks can look forward to significant opportunities to leverage from their existing capabilities. However, based on the findings of this whitepaper, it is important to re-emphasize that, technology forms the base for these banks to sharpen their competitive edge. From increasing its customer base to enhancing its market share and competing amongst financial institutions, the key is how wisely the technology is used to create differentiation and improve on profit margins. At this point, it is essential to discuss the following top 6 technology-driven critical success factors.

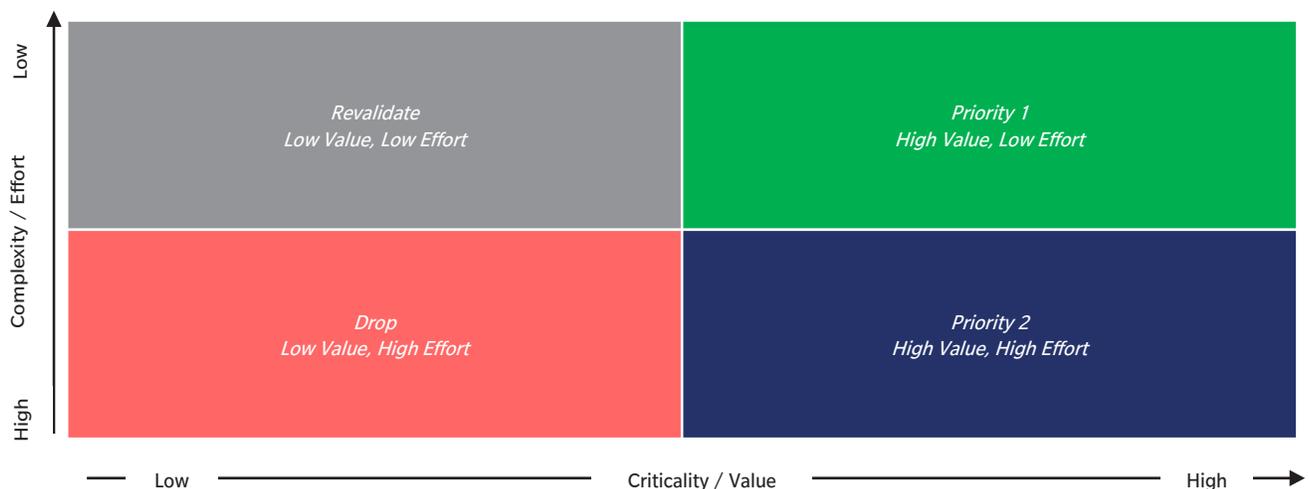


In the purest form of words, customers expect banking services to be available to them 24X7 (Availability). Further, customers expect the available systems to be accessible across channels of their need (Accessibility). From a technology perspective; it primarily translates into designing a robust enterprise architecture. Further, understanding the channel usability amongst different customer segments is imperative. A key consideration here is to have a consistent and seamless experience across channels for which financial institutions adopt an omnichannel hub.

Banking++

Banking services are moving towards implementation of a marketplace. A one-stop-shop for all the financial and sometimes, non-financial services. From a technology perspective, it requires a solution which can easily integrate with other internal and third-party solutions to exchange information seamlessly (interoperability). API and Open Banking are widely accepted technologies that enable interoperability.

Smart Digitisation



One size fits all is a big 'no' regarding digitisation. The effort involved in implementing digitising tools and solutions is only 15% of job done. The balance of 85% is in planning for smart digitisation, i.e., identifying areas of banking services and internal processes that require digitisation. Financial institutions spend months together trying to convert their digital strategy into actions. The adjacent figure shows a simple matrix for prioritisation. Financial institutions need to estimate the effort involved and measure that against the value/return on investment. Mapping the initiatives as per the prioritisation matrix will bring better clarity on planning for smart digitisation.

Optimisation

Optimisation can be easily related to the CQT Framework (Cost, Quality and Time)

- Optimisation required in managing Cost associated with operations
- Optimisation in maintaining Quality of Processes and People
- Optimisation needed in managing Time to service customers

For a financial institution, efficiencies using the above framework is one approach to increasing profit margins. Technology, in the form of automation and machine learning extends a helping hand here.

Security

Typically, in a financial institution, 40% of cybersecurity attacks go undetected for more than a week. The average cost of a data breach for financial institutions worldwide is reported to be US\$ 4 Mn. These numbers indicate the need for a proactive cybersecurity solution rather than reactive. Banks across tiers are joining hands to fight cybersecurity using sharing of technology resources. Early detection of fraudulent accounts, cognitive learning real-time transaction monitoring systems, and enterprise fraud management systems are typical solutions being adopted by CIOs and CTOs across financial institutions.

Analytics

As the saying goes, "Data is the new oil." Financial institutions have been building data models to understand not only the transactional aspects of the customer but also the behavioural and sentimental elements. New product strategies are being developed backed by robust data analytics. Cloud-based big data and data lake implementations have grown between 18-25% across geographies among mid-sized banks. Tier 3 banks are still able to manage with macro-based tools for predictive modeling. While the tools and solutions vary, the need for analytics is not to be underestimated.

07 CONCLUSION

Darwin once famously quoted it is not the strongest or the largest, but the fittest that survives. The banking industry is no different. In conclusion, the power of technology enables a much more level playing field and allows the smaller players to take on the competition with the giants. When digitisation eliminates the need for physical presence and enables error-free execution without layers of manual validation, the smaller players are naturally the beneficiaries of the tailwind. Further, tier-2 / tier-3 banks require each of the technology-driven critical success factors, discussed in this whitepaper, to be considered to sharpen the competitive edge. It is not a one-time fix but a continuous process of evolution by innovation.

How to contact ERI

www.olympicbankingsystem.com

GENEVA Tel. +41 22 342 12 29
LUGANO Tel. +41 91 913 95 00
ZURICH Tel. +41 44 204 93 00
PARIS Tel. +33 1 55 37 85 85

LONDON Tel. +44 203 457 9880
LUXEMBOURG Tel. +352 46 10 50 1
SINGAPORE Tel. +65 6622 5959

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