CATERPILLARS, BUTTERFLIES & UNICORNS

Does digital leadership in banking really matter?

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Alan McIntyre: Hi, I'm Alan McIntyre, Accenture's Global Banking practice lead.

If you've been keeping up with recent changes in the global banking industry, you may have noticed that three types of creatures have emerged in the banking menagerie.

There are pedestrian caterpillars who are legacy banks, with extensive branch networks, decades-old systems, an unfocused business model of being most things to most people, and who are struggling with the transition to becoming a digital-first bank.

But there are also legacy banks that have morphed through an often-multi-year chrysalis stage to emerge as digital-first butterflies, combining efficiency gains with upgraded customer experiences and smart ecosystem curation.

Finally, there's the digital-native challenger unicorns, with viral customer acquisition, multi-billion-dollar valuations and the confidence that they are going to truly disrupt the traditional industry.

The promise of digital transformation is that with the right mix of strategic focus, talent, creativity and investment funding, that caterpillars can turn into butterflies and that those butterflies can then go on and compete with the unicorns.

So, we asked ourselves a question: Does digital leadership truly matter? Is being a digital leader enough to drive high performance in the banking industry or does the impact of digital get swamped by interest rates, regulatory concerns and market-specific factors?

In this video I'm delighted to share with you the results of that research.

First, there is now little argument that we are entering a period of disruption in the banking industry. Every year, Accenture Research does a multi-industry study where we measure two dimensions: How vulnerable is an industry to disruption and how much disruption is actually visible?

For a long time, it feels like we have been a "Cassandra", because banking has been in the bottom right hand quadrant, vulnerable to disruption but still not seeing the change actually happen. But this year banking moved to the top right-hand quadrant where the volatility and disruption is now more visible.

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AM: That is hardly surprising when you look at the market structure analysis we published in late 2018. In Europe as a whole, one-third of revenue growth is now going to financial services companies that didn't exist in 2005, with the UK being the most disrupted—with 15 percent of its current total revenue and over 60 percent of its revenue growth leaking to new entrants. When you look at customer numbers, the disruption is even more dramatic. We think challenger banks active in the UK have 13 million accounts and with their current growth rates, they could double that number in the next year. So, the long-anticipated structural change in the industry does appear to be happening—at least in some markets.

Bank investors appear to share our view that banking is being disrupted. After the tribulations of the global financial crisis, the banking sector has clawed its way back to a return on equity that puts it in the middle of the pack when compared to other industries—and remember, there is now a lot more equity than pre-crisis. Yet, when you look at market valuation metrics like price-to-book or price-to-earnings, you see banking languishing near the bottom of the sectoral league tables.

The message investors are clearly sending is that, yes, current returns are back close to the cost of capital, but there isn't confidence that there is future value in the traditional bank business model. Instead, it is the publicly traded fintechs, targeting short-term growth rather than profits, that have valuations that are based on future growth potential. So, if you just look at the stock market, you might conclude that incumbent retail and commercial banks are a bunch of caterpillars that are unlikely to emerge from their cocoons and suddenly acquire the ability to fly.

But the story is not homogenous. For any individual market, the performance of the banking sector and the rate of change is determined by a combination of macroeconomics, regulatory factors and market maturity. For every UK example where new banks are acquiring millions of customers, there's equally compelling counter examples. In Canada, for example, the combination of smart regulation, sustained customer loyalty and continuous innovation by incumbents has blunted the pick of many venture capitalists, resulting in a stable industry structure with loyal customers that consistently delivers attractive shareholder returns.

Those market differences have resulted in very different market-level profitability dynamics post-crisis—as you can see in this chart—that shows profit before tax for the major banks in each market indexed back to the good old days of 2006. One major takeaway is clearly that banks in Europe and the UK are still not back to the absolute levels of profit that we saw pre-crisis.

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AM: So, digital maturity is clearly not the only thing that matters when it comes to bank performance. But the question we posed in our research was does digital maturity have enough explanatory power to separate out the high performers from the rest of the industry despite the impact of these other factors?

Before trying to figure out whether digital maturity does drive superior performance, we first needed to segment our sample of banks based on their degree of commitment to digital and the magnitude of their change effort. To do so, we took the largest 161 retail and commercial banks from 21 countries and went through a three-stage process to assess their digital maturity.

First, we looked for external validation from other industry analysts and observers regarding those institutions that are "all in" on digital banking. So, we looked at who was winning awards and generally being recognized by third parties as digital leaders.

Second, we looked at what those banks were saying about themselves by analyzing earnings call transcripts, news releases and stated investment budgets, to assess the extent of their digital transformation efforts. We were looking for banks that were both talking the talk and putting their money where their narrative was, either through internal investments or by making acquisitions or forming partnerships in the digital space.

Finally, we applied our own subjective judgement. Our client work around the world allows us to draw our own conclusions about which banks are truly committed to becoming butterflies versus those that are just putting digital lipstick on their caterpillar.

Within the 161 banks we analyzed, we ended up creating three segments:

Nineteen we categorized as "Digital Focused". This is a small group of banks that appears to be fully committed to digital transformation and has been investing to make it happen. Although none of them are fully there yet, the shape of these butterflies is becoming pretty clear.

Sixty-one we categorized as being "Digitally Active". Members of this group are in the transformation phase and have many initiatives that they can point to that show they want to be butterflies. Yet, they lack an overall sense of coherence to their efforts and haven't been telling quite as compelling a story or demonstrating the same change metabolism as the Digital Focused group.

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AM: Finally, we characterized over half our sample—81 banks—as “The Rest”. This is the group that hasn’t made much visible progress on digital transformation and may still be toying with the idea of whether to build a cocoon and launch a true enterprise-wide transformation program.

While we tried to be objective about the current digital maturity of this group, we didn’t try to read into the lack of progress—whether it’s intentional, based on the premise that being an upgraded caterpillar is a robust competitive strategy, or whether members of this group have butterfly aspirations, but just haven’t been able to initiate and sustain an effective change program.

Having created this segmentation, the next step was to decompose the banks’ financial performance to test whether our evaluation of digital maturity has explanatory power.

We started with market valuation and showed that it does seem to be correlated—and increasingly so—with digital maturity. Overall, Digital Focused banks are the only group with a price-to-book ratio above 1x and the gap to the rest of the industry is widening. While that indicates some confidence in future profit growth, these digital leaders still trail many Big Tech and fintech players that trade at significantly higher multiples.

One potential criticism of this analysis is that we’re reading too much into digital maturity and what we’re really observing is just a set of high-performing banks that address whatever challenge is in front of them—and at that moment that is digital transformation. While that may be true to an extent, the way in which the Digital Active group has overtaken The Rest in a reversal of the 2011 ranking indicates that there is explanatory power, we think, in the digital-maturity variable.

That being said, we also do need to be mindful that, while digital maturity seems to have explanatory power with respect to the market valuations, it certainly isn’t deterministic. Average price-to-book values show distinct differences across the three digital groups; however, the distributions do have a high overlap. This indicates that digital maturity is just one among many important performance variables and that all other things being equal, from an investor’s perspective, being a bank in a favorable market, like Canada or Australia, may still be a far bigger driver of returns than being a digital leader in a challenging market like Germany.

Having established that digital maturity is associated with differences in market valuation, the next step was to look at whether those valuation differences are justified by better operating economics or are the valuations just floating on a cloud of digital hype?

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AM: We found that digital maturity does seem to be associated with increased profitability. From a position in 2011 where there really wasn't much difference in ROE between the three groups, we now see separation occurring—and analysts' expectations are that the gap will continue to widen through 2021. While both Digital Focused and Digital Active banks are increasing returns, the concerning finding for The Rest is that returns look to remain below 2011 levels for a while to come, despite generally positive macroeconomic conditions.

The next logical question to ask was what is driving the superior operating economics of the digital leaders?

When we look at digital success stories in other industries outside of banking, like say an Uber, we tend to think about hyper revenue growth and a frenetic landgrab for market share and customer adoption, with profitability coming later. And as I commented earlier, that's the playbook that the unicorn banks are following, with customer acquisition numbers acting as a proxy for future profit opportunities.

However, the story for the incumbent banks is clearly very different. The most highly valued and most profitable banks are in the Digital Focused group, but they're achieving that profitability through higher operating leverage that squeezes more profit out of every dollar of assets rather than superior growth.

The Digital Focused banks grew their operating expenses at just half the rate of their revenue growth over the last six years. While the Digital Active group did open the jaws on operating leverage, it did so to a lesser extent, while The Rest created almost no operating leverage at all.

What is perhaps more surprising is the clear inverse relationship between operating leverage and both revenue and asset growth, with the highest growth in both coming from banks that made the least progress on digital.

One possible explanation is that, while the Digital Focused group concentrated on change and evolution, the caterpillars are just munching their way through stacks of leaves, content to bulk up in their existing business model. It's also worth noting that revenue growth is lower than asset growth for all three groups, indicating industry-wide margin compression over the last six years.

Another interesting conclusion from our research was that the better you get at digital, the more your income tilts towards balance sheet spread. Not only do the averages show a marked shift towards net interest income for the Digital Focused group, but even at the individual bank level, the vast majority of Digital Focused banks saw NII increase faster than non-interest income over the last six years.

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AM: One rationale for this is that as you become more digital, the justification for fee income—either to pay for advice or administrative work—diminishes. Instead, what becomes more important is being paid for the risk taking—both interest rate and credit—associated with running a traditional balance sheet.

If traditional sources of fee income are being squeezed in a secular fashion by digital, the next question is, can they be replaced by new sources? We think they can, but to do so banks will have to challenge their current business model.

Our customer research shows that between a third and a half of customers are willing to consider broader propositions from their banks, and that around a quarter are willing to pay extra for them—indicating that there may be new sources of fee income for banks, ranging from facilitating the broader home-buying process to providing end-to-end car care—from purchase through insurance, to repair and maintenance coverage.

So, whether you're a CEO, a Chief Strategy Officer or especially a Chief Digital Officer, take a step back and ask the hard question: Is your bank about to emerge from the chrysalis you have spent the last few years trying to build or are you feeling that you’re stuck on the forest floor?

Whatever your level of digital maturity, we believe that the roadmap to becoming a butterfly and competing effectively with the challenger unicorns is now becoming clearer.

We see many common characteristics of those banks who have made the transition and are now taking flight. Those include a commitment to true enterprise agility to raise the change metabolism of the organization. Also, a pivot towards a culture that balances a respect for traditional bank skills like credit analysis and customer service, with a respect for engineering and software skills as a critical in-house capability.

The butterflies also tend to default to public cloud for infrastructure, putting the burden of proof on the status quo rather than hiding behind regulatory concerns to slow the migration to a data-intensive and scalable public cloud business.

They’ve also invested in digital decoupling to overcome legacy technical debt and provide products and services that can be accessed and consumed by both internal bank customers, but also external third-party providers, in a world of increasingly open banking.

The butterflies also aggressively migrate their tech spend from “run the business” initiatives to “change the business” initiatives, with an ambition to move towards a zero-marginal-cost operations environment as each customer is added.

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AM: Finally, the best banks we work with manage to combine an aggressive butterfly-building program with a focus on maintaining security, compliance and resilience as the foundations of customer trust.

This can all be a daunting to-do list for the caterpillars on the forest floor, but as we have demonstrated, the performance gap between the best and The Rest is increasing, and with the unicorns getting bigger and stronger, the risk is that caterpillars end up on the endangered species list over the next few years.

So, what are the key takeaways from our research?

First, the banking industry is changing and disruption is real, but market-specific factors still play a huge role in the speed and magnitude of that change.

Second, that digital maturity does help explain both market-value premiums and improved operating economics. But those improved operating economics are principally the result of efficiency rather than growth at the moment.

Third, that as you become better at digital you tend to cannibalize your own traditional fee income streams, increasing the importance of exploring how banks can serve a broader set of customer needs.

Finally, for a caterpillar to turn into a butterfly, it needs to eat itself and use the energy that is liberated to build around a new set of DNA. The same is true for banks. The level of cultural and technological change required to become a butterfly shouldn't be underestimated but were beginning to see a standard playbook emerge for how to make that transition a success.

Thank you for taking the time to watch this video. I hope you find our research of interest and that it prompts you to question where your institution currently is on the transformational journey from caterpillar to butterfly.