ECONOMIC SITUATION AND STRATEGY

April 9, 2019

Emperor's new clothes: Digital transformation of bank products and marketing

Banks have always been leaders in digitalizing business processes. At the same time, an epic change attending the digital transformation is under way in the financial services industry. But what is the difference between digitalization of business processes and digital transformation?

Digitalization: Just old wine in new bottles?

The disruptive potential consists in the radical way the digital transformation changes how we interact with our environment, in both private and business life. The ways in which we communicate with other people have changed substantially over the last decade, since the development of the first iPhones. The same goes for how we use the media and how we inform ourselves or consume films and music. The patterns of how our needs are created and how we experience brands and make shopping decisions have changed completely. A large part of our lives now takes place online. However, that has nothing to do with digitalization of business processes.

Successful digital transformation for banks means accompanying this process of change to remain part of customers' real lives, to be happening where customers spend time and form their preferences, wishes, and brand perceptions. With products integrated into this digital customer journey so that "genuine" relationships can evolve from contacts. With products and services that become embedded in the newly learned patterns. This gives rise to two action fields, one for products and one for marketing and distribution.

Evolution through digital products

The first evolutionary step in digital transformation is the launch of "digital products" that are offered, transacted, and serviced online. Digitalized asset management clearly illustrates this. It takes the form of a robo-advisor with the individual customer's investment strategy determined by means of an online question path, and an account opened online thanks to video identification. The digitalized service can thus be offered to entirely new customer groups thanks to lower unit costs. Another example would be consumer and mortgage loans. In digitalizing various process, documentation, and control steps, it is not primarily a matter of efficiency gains, though gladly accepted as byproducts. The crucial factor is the competitive advantage on the customer side, the creation of binding terms and conditions and immediate approval or cancellation at a click. Personal finance managers (PFMs), apps that aggregate account and portfolio data over various banking connections, go a step further. Good ones can detect an important added value of a digital service, e.g., a helpful feature such as budget control for planning receipts and outlays. A different customer segment is the target of PFM extensions that supplement those by adding illiquid assets like real estate in order to allow a truly holistic approach to asset analysis.

Disruption through digital business models

Technology trends like the API economy and cloud solutions, after arriving in other sectors, are now reaching the financial industry. Here, too, they are leading to increasing fragmentation of value chains and specialization regarding products and customer segments. This is the basis for business models that can lead to entirely new market dynamics. To illustrate this development, we refer to Tomorrow Bank, which has dedicated itself completely to sustainability. All the financial services that it offers supposedly comply with sustainability criteria. Money as a part of the solution for a more sustainable world, that is the claim.

The interesting thing that Tomorrow shares with other digital business models is that it does not involve new product lines from established providers, but rather startups. Integrating partners makes it possible to operate independently as a financial service provider. Even though substantial parts of the added value are rendered by third-party developers, Tomorrow owns the customer relationship, not the (bank) partner in the background. Focusing on a special area creates trust, which increases conversion and balances marketing budgets through greater SEO (search engine optimization) online visibility. It involves an innovation that again does not come from banks, but rather from financial technology (fintech). In the case of Tomorrow, not even the founders of the company are from the financial services industry.

After disruption: Beyond banking

The concept of "beyond banking" has an almost esoteric connotation. The idea is to completely rethink the relationship between banks and customers in a digitalized world. What does that mean? A comparison with the automobile industry is useful. One often hears that companies there want to transform from vehicle manufacturers into mobility service providers. The underlying idea is that what customers really care about is transportation from point A to point B. The companies want to help shape the change as such mobility becomes possible and occupy the new forms of business. A less prominent example is that of agricultural equipment manufacturer John Deere, which launched the platform MyJohnDeere.com in 2012. Farmers could upload their data to the platform and enhance it with other data on the weather, seed, and soil conditions to increase their productivity by means of "big data" and artificial intelligence. The platform has an open design and allows third-party developers to integrate their own value-added services. It is the same basic idea as before. What matters to the farmers is to make their operations efficient, not to have the best tractors. To the extent that other aspects become more important for efficient operation, those are likewise to be represented. And the platform does exactly that. John Deere thereby safeguards sales of its tractors against competitors, since they are not integrated into the platform. Moreover, the company protects itself from intruding technology providers with similar ideas.

How do I handle services delivery?

Besides the products, the second job site is banking services delivery. The traditional, purely analog relationship approach to delivering private banking services is obsolete. The customer advisor's tools, including networking events in-house or elsewhere, invitations to come to the bank and become acquainted, or recommendations from existing customers, do not work often enough. The number of talks a customer advisor conducts today in which the other side exhibits desire and potential for interesting business often stands in unhealthy relation to the expense incurred beforehand to get into such situations. Increasingly, this approach is wearing thin.

Rather go to the dentist than to the bank?

Why is that so? The basic problem is not that people today prefer going to the dentist over going to a bank – at least so goes a clever line gladly repeated among bankers. No, the digital transformation in which we find ourselves is also decisive here. It is because our lives, as described above, are increasingly happening online. This new pattern needs to enter into the communication of what providers offer and to be present online. And online presence does not end with shifting marketing budgets from traditional media to the internet. The point is to create as many contact points as possible and use them to make potential customers aware of the products and their individual benefits, motivate them to switch, and attract them to the provider's brand and services. Properly realized, the benefit of the various digital channels for programmatic appeals to target customers is more efficient that the pure relationship approach in the outbound direction. That does not mean that everything will always take place online with no need of personal contact. The emergence of hybrid approaches in which "digitally" incoming contacts are received by "analog" elements shows what potential there is in combining traditional and digital approaches.

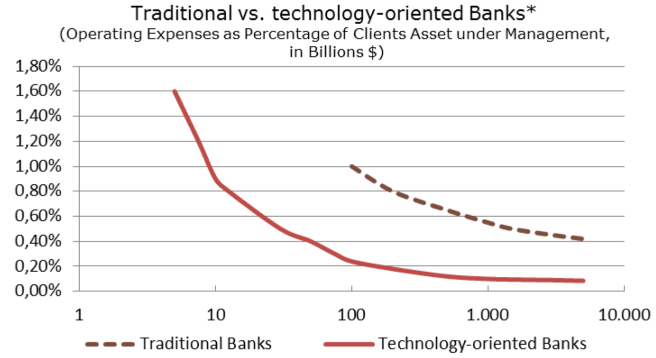
Another aspect arises in online marketing, i.e., in-depth content analysis of the customer benefits to be generated, the products, and the market environment as the starting point for all action. What do the typical customer personas look like? What contact points and topics attract them to the brand and products? What content is relevant, at what time? How can access be offered and trust established early with digital tools and services? The insights gained here form the basis for optimizing existing products and developing new ones – the digital products and business models discussed above. Marketing thus becomes an integral component of communication and product development. Here, digitalization means more than simply shifting marketing budgets. And rethinking for those who have previously got along without marketing. For, without online presence, one remains invisible for a broad class of target customers.

Banking as "scalable service"?

Banks that systematically pursue this path and include technology in targeting customers and providing their services will be able to scale their products. At first, that may sound like a matter of course. After all, people always like to throw in the notion of scalability. But in fact, banks have almost never achieved scalability in their long history. Traditionally, volume expansion in private banking has almost always entailed correspondingly more employees.

A comparison of the expense ratios (operating expenses to total assets under management) of traditional versus technology-driven providers, as presented by Morningstar-PitchBook in its publication "Robo-Advisor Upgrade" (June 2018), clearly illustrates this development. For financial service providers with a traditional marketing approach, the study yields a floor cost of 60 to at best 40 basis points even with very large volumes of assets under management. A different picture emerges for technology-oriented providers. And not only for the early providers of robo-advisors, but also for established providers, like Charles Schwab, that have geared their business models systematically to technology. They already show significantly lower expense ratios on smaller volumes, which convert to almost zero on large volumes. The simplified presentation of the study's results make this difference clear (see chart).

A likely reason for this striking cost advantage surely lies in the digital concepts described above. But the authors of the study identify the reason elsewhere. In traditional private banking, the customer relationship is strongly shaped by the personal relationship between customer and advisor. The advisors are rewarded for such relationships in the form of variable salaries, depending on the volume acquired or advised. The compensation model thus sets an inherent limit on "scaling". The situation is different in the case of digitalized products. Here, the (initial) customer talk does not take place at the level of personal relationship, but rather online. The service promise is not originally made with individual persons, but is rather defined by way of competence and brand. Trust becomes established through various digital (and analog) contact points. The bank becomes the owner again of its customer relationship.



Don't sleep through digital transformation

Given these figures, it is perhaps amazing that the digital transformation is too often dismissed as simply a matter of business process digitalization. Like sleepwalkers, some bankers seem to cling to their practiced and dearly held ways and believe nevertheless to have the digital transformation fully under control. A common "repression pattern" is the belief that bad things will always happen to others, the ones with less stable customer relationships, brands, or products. The fact that regulation constitutes a barrier to market entry for non-industry players and financial services presuppose cultivated trust is projected indefinitely into the future.

"Banking is necessary, banks are not," said Bill Gates 25 years ago. Banks have managed to resist that for the most part, and many fintechs have changed from competitors into partners. Nevertheless, the digital transformation will dramatically change how banks establish customer relationships, generate customer benefits, and orchestrate value creation in the future. In some instances, banks will also have to reinvent themselves. Those that clearly understand the core of their customer relationships and the form it takes in a digitalized world are well positioned to profit from this transformation and to counter competition from new market participants from other sectors. Scalability of their own products can thus become reality, a cost advantage that cannot be overestimated in a period of historically low interest rates and yields.

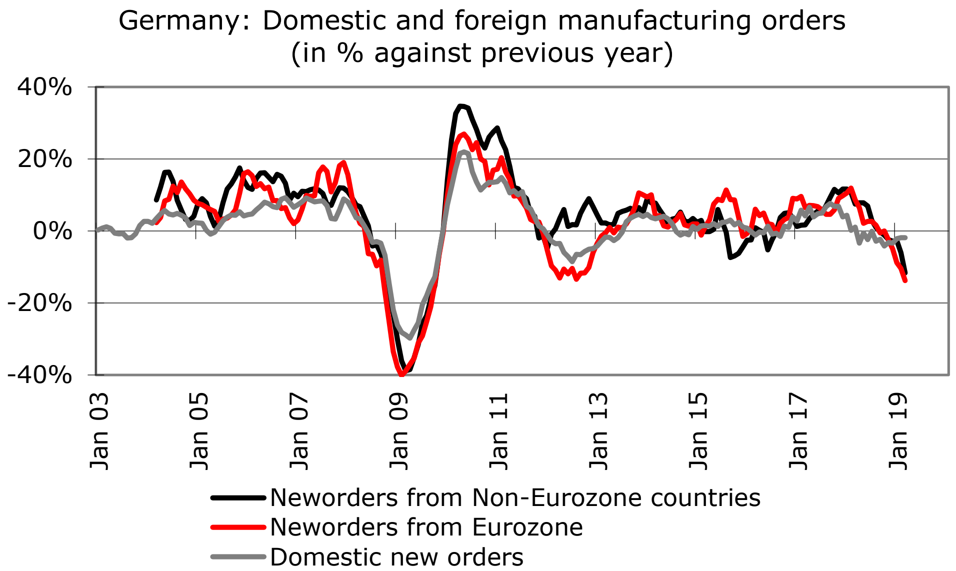
We are grateful for the kind support of our colleague Jan Kühne.

Weekly Outlook for April 8-12, 2019

	Nov.	Dec.	Jan.	Feb.	Mar.	Apr.	Release
DE: Consumer prices, m/m – final	-0.7%	0.0%	-0.8%	0.4%	0.4%		April 11
DE: Consumer prices, y/y – final	2.1%	1.6%	1.4%	1.5%	1.3%		April 11
EUR19: Sentix	8.8	-0.3	-1.5	-3.8	-2.2	-2.0	April 8
EUR19: Industrial production, m/m	-1.5%	-0.9%	1.4%	-0.5%			April 12
EUR19: Industrial production, y/y	-3.0%	-3.9%	-1.4%	-0.9%			April 12

MMWB estimates in red

Chart of the Week: German industry still in downtrend



Worries about German industry are growing. After purchasing manager indexes already pointed to a further weakening of the secondary sector, the latest data on new orders are contributing to uncertainty. Surveys in February show industrial new orders down 4.2% overall, accelerating from -2.1% in the preceding month. We also see a pronounced divergence of domestic and foreign demand. While new orders from domestic customers were down by only 1.6%, the decline of foreign orders was significantly greater at 6%. Orders from countries outside the euro zone dropped very sharply. At almost 8%, their decline was the worst in the last ten years. A report from Germany's Mechanical Engineering Industry Association (VDMA) goes in the same direction, showing even earlier a sharp downturn of new orders from outside the euro zone by about 16%. This development reflects the worries and hence great uncertainty caused by political factors like Brexit and the US-China trade dispute, which are weighing heavily on international commerce. So, given the decline of orders, we do not expect any significant improvement of industrial business in the coming months. There is nevertheless some reason for hope, starting in China. For one thing, it appears that the US-China trade dispute might be ending. For another, the stimulus measures taken by the Chinese government should bolster foreign demand again in the future. Until that time, however, German economic growth will depend on the services sector, which can withstand the negative influences from abroad with strong domestic demand.

Market Data Overview

	As of	Change versus				
	09/04/2019	02/04/2019	08/03/2019	08/01/2019	06/04/2018	31/12/2018
Stock marktes	10:56	-1 week	-1 month	-3 months	-1 year	YTD
Dow Jones	26341	0,6%	3,5%	10,7%	10,1%	12,9%
S&P 500	2896	1,0%	5,6%	12,5%	11,2%	15,5%
Nasdaq	7954	1,3%	7,4%	15,3%	15,0%	19,9%
DAX	11972	1,8%	4,5%	10,8%	-2,2%	13,4%
MDAX	25350	0,8%	4,3%	12,7%	-1,2%	17,4%
TecDAX	2767	1,7%	5,3%	9,8%	10,7%	12,9%
EuroStoxx 50	3438	1,2%	4,7%	12,5%	0,9%	14,5%
Stoxx 50	3177	0,6%	4,9%	13,0%	5,5%	15,1%
SMI (Swiss Market Index)	9584	0,5%	3,4%	11,1%	10,5%	13,7%
Nikkei 225	21803	1,4%	3,7%	7,9%	1,1%	8,9%
Brasilien BOVESPA	97369	2,1%	2,1%	5,8%	14,8%	10,8%
Russland RTS	1250	2,8%	6,0%	11,3%	1,1%	17,2%
Indien BSE 30	38815	-0,6%	5,8%	7,9%	15,4%	7,6%
China Shanghai Composite	3240	2,0%	9,1%	28,2%	3,5%	29,9%
MSCI Welt (in €)	2153	0,3%	4,4%	12,8%	13,8%	16,0%
MSCI Emerging Markets (in €)	1089	0,9%	5,1%	13,2%	1,6%	14,4%
Bond markets						
Bund-Future	165,36	-75	97	162	586	182
Bobl-Future	132,85	-30	41	30	163	33
Schatz-Future	111,90	-9	7	1	-4	-4
3 Monats Euribor	-0,31	0	0	0	2	0
3M Euribor Future, Dec 2017	-0,31	0	-2	-9	-34	0
3 Monats $ Libor	2,59	-1	0	-19	25	-22
Fed Funds Future, Dec 2017	2,27	6	-9	-17	-15	0
10 year US Treasuries	2,52	4	-11	-20	-26	-17
10 year Bunds	0,01	6	-6	-22	-49	-23
10 year JGB	-0,05	2	-2	-5	-9	-5
10 year Swiss Government	-0,29	13	12	-6	-29	-5
US Treas 10Y Performance	593,40	-0,3%	0,9%	2,3%	4,8%	2,2%
Bund 10Y Performance	645,70	-0,5%	0,7%	2,8%	6,3%	2,9%
REX Performance Index	491,38	-0,2%	0,2%	0,9%	2,2%	0,8%
US mortgage rate	0,00	0	0	0	0	0
IBOXX AA, €	0,50	4	-11	-44	-31	-38
IBOXX BBB, €	1,44	2	-24	-72	3	-62
ML US High Yield	6,64	-6	-33	-81	13	-138
JPM EMBI+, Index	838	-0,2%	1,5%	4,0%	2,0%	5,9%
Convertible Bonds, Exane 25	7264	0,0%	2,3%	4,8%	-0,7%	5,4%
Commodities						
CRB Spot Index	425,23	-0,3%	2,6%	2,8%	-2,8%	3,9%
MG Base Metal Index	317,92	0,2%	1,3%	8,0%	-5,7%	7,9%
Crude oil Brent	71,28	2,5%	8,3%	22,2%	5,6%	34,2%
Gold	1301,08	0,8%	0,2%	1,3%	-2,3%	1,5%
Silver	15,24	1,1%	-0,8%	-2,5%	-7,1%	-1,7%
Aluminium	1844,50	-1,0%	0,0%	-0,1%	-8,8%	-1,0%
Copper	6459,75	0,7%	0,6%	9,7%	-4,0%	8,6%
Iron ore	93,63	4,6%	10,0%	26,2%	47,8%	35,3%
Freight rates Baltic Dry Index	714	5,9%	10,0%	-43,4%	-24,7%	-43,8%
Currencies						
EUR/ USD	1,1278	0,7%	0,5%	-1,4%	-7,8%	-1,5%
EUR/ GBP	0,8603	0,2%	-0,3%	-4,3%	-1,2%	-4,2%
EUR/ JPY	125,52	0,6%	0,6%	0,9%	-4,4%	-0,3%
EUR/ CHF	1,1259	0,6%	-0,6%	0,2%	-4,6%	-0,1%
USD/ CNY	6,7094	-0,2%	-0,2%	-2,1%	6,4%	-2,4%
USD/ JPY	111,49	0,1%	0,3%	2,5%	4,3%	1,7%
USD/ GBP	0,76	-0,6%	-0,7%	-2,8%	7,5%	-2,8%

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