INVIGORATING BANKING

FEBRUARY 2015

INVIGORATING BANKING

REPORT ON A SURVEY BY FINEXTRA AND FIVE DEGREES

five degrees™ | Finextra

INVIGORATING BANKING

REPORT ON A SURVEY BY FINEXTRA AND FIVE DEGREES

Finextra Research Ltd
101 St Martin's Lane
London
WC2N 4AZ
United Kingdom

Telephone
+44 (0)20 3100 3670

Email
contact@finextra.com

Web
www.finextra.com

00
CONTENTS

01
INTRODUCTION

1:1 Finextra Research

This report is published by Finextra Research.

Finextra Research is the world's leading specialist financial technology (fintech) news and information source. Finextra offers over 100,000 fintech news, features and TV content items to visitors to www.finextra.com.

Founded in 1999, Finextra Research covers all aspects of financial technology innovation and operation involving banks, institutions and vendor organisations within the wholesale and retail banking, payments and cards sectors worldwide.

Finextra's unique global community consists of over 30,000 fintech professionals working inside banks and financial institutions, specialist fintech application and service providers, consulting organisations and mainstream technology providers. The Finextra community actively participate in posting their opinions and comments on the evolution of fintech. In addition, they contribute information and data to Finextra surveys and reports.

For more information:
Visit www.finextra.com, follow @finextra, contact contact@finextra.com or call +44 (0)20 3100 3670

1:2 Five Degrees

About Five Degrees

Five Degrees is a financial technology provider delivering next generation banking software to retail and private banks. With offices in the Netherlands, Iceland and Luxembourg, the client and partner base of Five Degrees encompasses retail banks, asset managers, online savings banks, law firms and Greenfield operations in the financial services industry.

About Matrix

Matrix offers a future facing fully automated banking services platform supporting any segment, product or channel through a rich mid office environment, connected to any (legacy) back-office of choice, or the available Matrix back office. Matrix by Five Degrees is leading the banking market in its transformation. Award winning bank Knab operates on Five Degrees Matrix.

Matrix operates in a fully automated model with an unparalleled level of self service at every touch point giving both customer and bank instant insight and control in the process. The Web-based mid office portal offers benefits in terms of efficiency in adapting new business processes on the go. The open services platform integrates with any external service like KYC checks, passport validation, PFM, etc. or any external banking services requested. Users deploy the technology through a portal in a number of pre-defined flavours: full retail and SME banking, savings bank, private banking or micro finance

For more information:

Visit: www.fivedegrees.nl, email to info@fivedegrees.nl
or call: +31 880086400

Follow Five Degrees on Twitter via: @fivedegrees

02
ABOUT THIS SURVEY

2:1 A snapshot of banking invigoration

This survey conducted by Finextra at the end of 2014 targeted financial institutions worldwide to take a snapshot of banks' efforts to retain or gain their customers' business and loyalty in the face of existing IT, operational, cultural and regulatory constraints. Much depends on how they interact with those customers, what services they offer and how they offer them. Most of today's IT environments cannot support those business wishes adequately – so what to do? Change the core banking platform? Build a new bank from scratch? Put a wrap around the old system and focus on the front end? How to invigorate your bank and the dialogue with your customers?

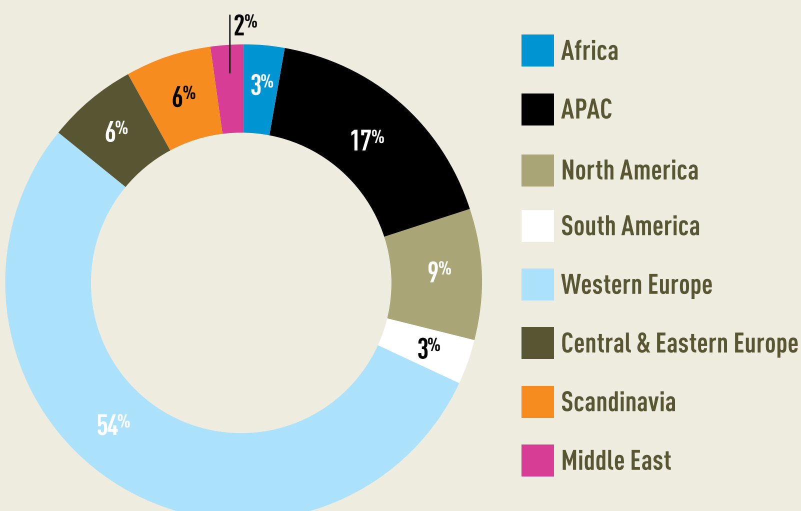
We used a six-point Likert scale to get respondents to show their level of agreement or disagreement with a number of statements about their business grouped under five themes – the perceived need for invigoration, the drivers, customers' changing demands, what's blocking progress, and the impact of new entrants to the industry. Throughout the analysis we have paid more attention to those who felt strongly either way, discounting those more neutral respondents who selected slightly agree or slightly disagree.

We received 126 responses from 96 different financial organisations and 38 countries. Where multiple responses came from a single large financial group they were frequently from different geographies or business units -- e.g. cards, retail, transaction banking or financial markets. 54% of respondents came from Western Europe, with the remainder spread worldwide. Where regional differences in responses were apparent, this has been noted in the analysis.

Sample job titles:

- CIO
- Head of innovation
- IT Director
- Vice president of operations
- Head of customer planning & insight
- Pricing bureau manager
- Head strategic change and business alignment
- Managing director
- Head of service delivery
- VP, customer experience
- Director, core banking systems
- Global head of ecommerce
- Chief strategy & marketing officer
- Director, retail channels

fig 1: **A SNAPSHOT OF BANKING INVIGORATION**



Respondents: 126

03
THE NEED TO INVIGORATE THE BANK

3:1 What is the right pace and area of focus for modernisation?

Modernisation is a broad and ever-evolving concept. What seemed like a modern technology and approach five years ago could now be seen as limited and constraining, depending on architectural approach, how it was implemented and how the business has since changed. But one thing is certain, and that is the bulk of IT in banks today is still far from modern.

The extent of the patchwork of systems ranging from 50 days to 50 years old in all but the smallest and newest financial institutions shows that modernisation efforts to date have been targeted. And short of launching new stand-alone greenfield banking entities, this will continue to be the case. But where should the investment go?

78% of respondents agreed or completely agreed that modernising the bank can be achieved by investing in multi-channel and front-end customer engagement. But this may not be enough to truly support the needs of the bank and its customers. 65% agree or completely agree that their bank's existing core technology can no longer support its needs.

3:2 Core system replacement overdue for many

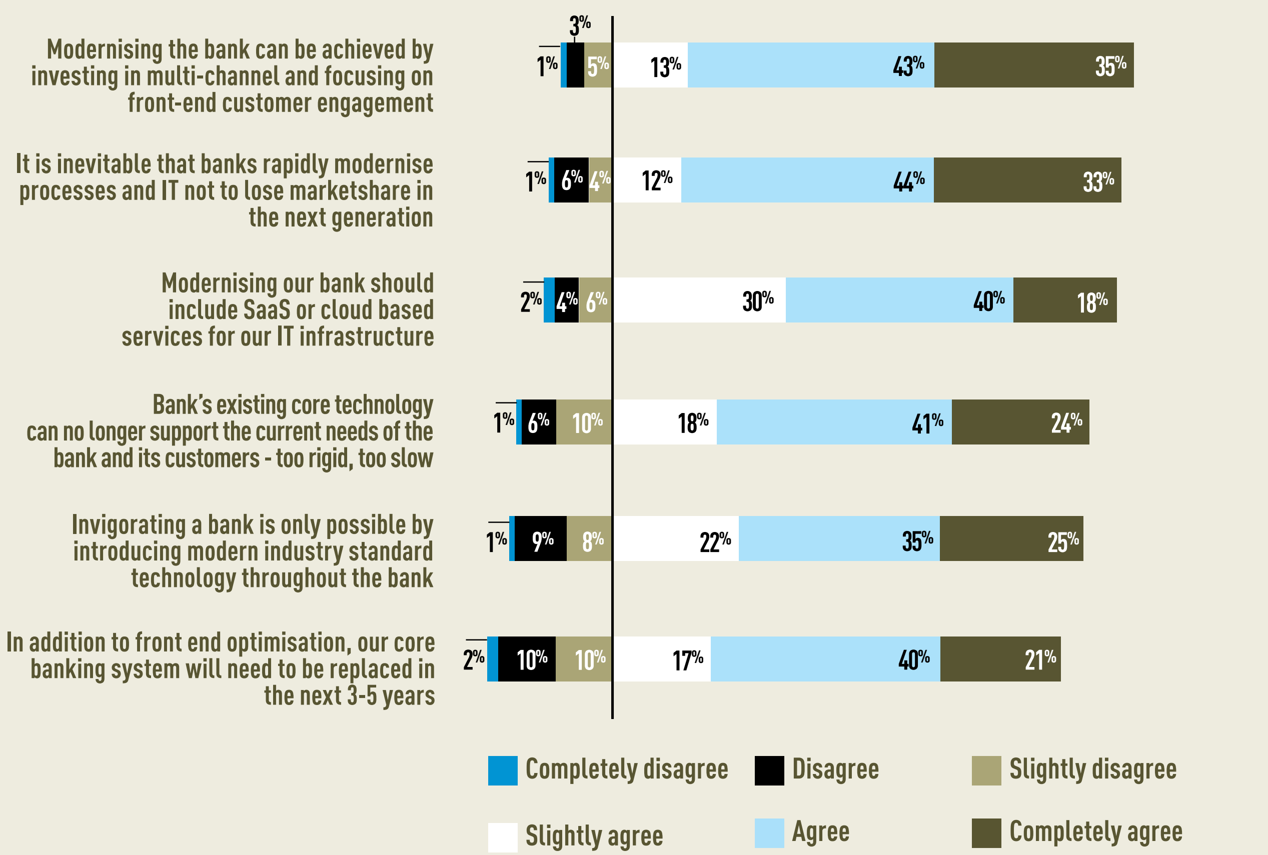
It is clear that many banks acknowledge that simply wrapping and skinning their existing core infrastructure is not enough. When you look at their plans for core banking system replacement, 61% of respondents agree or completely agree that core banking replacement will need to take place in the next three to five years. This rate was even higher when the respondents only from South America, Middle East, Africa and Central and Eastern Europe are considered together. Among banks from these regions, which contain mostly developing economies, 89% agreed that they would need to undertake replacement in this timeframe.

Although many respondents see the obvious need for replacement, there is no guarantee that such projects will be funded to proceed. As can be seen in section 9 of this report the risk, cost and perceived failure rates of such massive projects are a significant roadblock.

And so for many, despite the clear need for a more comprehensive revitalisation of IT systems and architecture, the easier option is to tinker around the edges with customer-facing channels or launch or invest in new standalone businesses and brands that can help the parent financial group embrace new customer engagement models and better compete with new entrants.

Any IT project today should involve the appropriate consideration of software as a service and cloud-based services. By eliminating the constraints of where physical IT resources are located or what specific technologies they employ, banks that go down this route hope to benefit from the rapid, low-cost formulation and deployment of new business services and new partnerships. Across all respondents, 68% felt strongly enough to agree or completely agree that these services should be part of their modernisation plans. But agreement was strongest in the Asia Pacific region, with 76% compared to just 51% in Western Europe.

fig 2: **THE NEED TO INVIGORATE THE BANK - MODERNISATION CAN HAPPEN AT THE EDGES, BUT CREAKING CORES STILL HOLD MANY BANKS BACK**



Respondents: 126

04
OPINION: CHRIS SKINNER

4:1 Focus upon the core – the rest will take care of itself

When I read the results of the Five Degrees report produced by Finextra Research, I was not surprised but reassured to see that many of the banks out there agree with the surmise that there are four big topics of change in their systems strategies. These are namely core systems renewal, cloud, analytics and innovation.

Why I am reassured to see this is that it's exactly what I've been saying for some time; you cannot become a digital bank without core systems renewal; you cannot renew core systems without using cloud for data management; you need to consolidate data in the cloud in order to be able to perform effective data analytics; and when you've renewed core systems through the cloud to perform data analytics, well then you can innovate.

Although some people talk about hot new technologies, like the internet of things and wearables, they're not priority at all. They are transient things that come and go like fashion. It is just fashion. A bit like mobile telephones, they come and go. This year's hot phone is the iPhone6, last year it was the Samsung Galaxy and before that the Nokia N95. In 2007, Nokia was worth more than Google or Apple. In 2007, Nokia was worth $150 billion; by May 2014, when Microsoft acquired what was left of this business, the value had fallen to just $7 billion.

That's what happens with the froth of consumer electronics, and banking is not consumer electronics. So banks will tinker with Internet of Things (IoT) and wearables, but this is not fundamental in the focus upon bank technology change.

The real focus is the digitalisation of core banking across the institution, and launching digital bank services. In practice, this means re-engineering core systems and processes to be built upon a digital core foundation, a massive change for some, and an incremental change for others.

This means the hot technologies in banking will be core systems renewal, cloud, analytics and incubators. I don't think that IoT, wearables, social media or other areas will be core on the banks' agendas. The reason is that these are the icing on the digital core cake, but the banks must first combine the key ingredients for that cake before they are fit to ice it.

Let's take a closer look at the four core areas where the investment dollars are going this year.

4:2 Core systems renewal

This has been bubbling away like an open sore filled with pus on the backside of banking for the last decade. The fact that most banks don't touch core systems that are years and sometimes decades old is a crime. That crime has now come back to haunt the doorstep of not just the CIO, but the whole C-Suite. Most would rather not bite the bullet, as their predecessors managed to avoid doing this, but it's now become so apparent that most core systems are not fit for purpose that it is no longer an avoidable issue. Batch, overnight, programmed systems that no longer have developers, analysts, architects, engineers, designers or managers who understand them have finally reached their end-date. Thank heavens. This does not mean all and every system has to change – mortgage systems, life assurance systems, pensions and some others cater for contracts that span a quarter of a century and can be left in cryogenic operation – but anything that demands real-time needs to be ready for the digital age.

A bank cannot be digital with a core system built for the last century.

4:3 Cloud

A digital bank has the internet at its core and, today, that means the cloud-based net. Cloud allows mainframe services through the network such that security, change, agility and control are all in the hands of the network management and cloud-based software. For the past seven years, most banks have been content to ignore cloud because they believed, wrongly, that it means open systems, insecurity and unreliability, loss of control and potential risk. These perceptions are all wrong, as I mentioned last year, as cloud has matured and covers a panacea of software-as-a-service, infrastructure-as-a-service, platform-as-a-service and more. This is where banks must invest in their agile service structures to offer banking-as-a-service (did I really start saying this six years ago? YES!).

Banks have to move to a component based model to deliver agile services and plug-and-play the best of breed into their operations. Where banks can fulfil all the components, great. Where they cannot, they need fast fixes by buying in services from those who do these things well.

This is why banks will move to cloud, as their competitive services will be maintained through internal control in a private cloud whilst shared services and components that have little competitive differentiation can be leveraged through public or hybrid cloud.

This is the future re-engineered financial model, as I've explained many times here, and banks get that this year as they move to digitalisation and core digital platforms.

A bank cannot have a digital core without the use of cloud to componentise the systems architecture and business model.

4:4 Analytics

Once banks cleanse their core and digitise it using cloud, then they have the opportunity to leverage their data. All banks talk about Big Data, but it's not the big data that counts but the small moments. In other words, cleansing and creating the enterprise data store is a huge challenge in itself but that is not the end game. The end game is to use that data, which is where the rubber hits the road. Therefore, data analytics is the competitive battleground in banking and, now that banks recognise they have to digitise, they also see that the data analytics opportunity of their new core will be a big strategic focus.

What this really means is not just customer propensity modelling for share of wallet, but using data intelligently to create opportunity and improve service. Maybe good examples are the BankAmeriDeals program and the work that Metro Bank has been operating in this area. Both are using data analytics to give customers great offers that are personalised at the point of relevance. BankAmeriDeals make mobile app offers based upon the stores you are nearby that they know you shop at; and Metro Bank makes personalised tweets to people who are near a branch for an account opening opportunity (usually when they've just tweeted how much they hate their existing bank).

Expect more and more of this sort of data analytics competitive affray over the coming year, as this is the space that's really hot, hot, hot once the bank has digitised its core. Add on to this that the internet of things and wearables will be served and serviced by the quality of the data analysis that sits behind them, and this is the real golden egg of technology that is sitting there today.

Banks that digitise will differentiate with data, and the royalty of analytics will reign supreme.

4:5 Incubators

The first three areas I've outlined are re-engineering programs that banks are prioritising in their technology operations, but the fourth is the innovation and growth opportunity. This is because it does not involve messing about with redesigning the mess from the past, but focuses far more on creating the bank of the future. Most banks have some form of program in place for achieving these innovation incubators whether they call them accelerators, escalators or something else.

It doesn't really matter what they're called, but these incubators are growing. In London, we have Level39, Innovate Finance, the Barclays Escalator, Fintech Start-up Bootcamp and more. American Banker cited nine great incubators out there, from Bank of America's Lab to Bank Leumi's hackathon. Hackathons, Open Source Challenges, the API buzz and more are all big technology focal points in banks, and this is just going to get bigger. Bear in mind there's also more breeding grounds for start-ups and VC's to meet, like Finovate and the Innotribe start-up challenge; and then add on venture funds of the banks such as Citigroup, Sberbank, HSBC and Santander; and what we're really seeing is banks recognising that if fintech is where it's hot, then they need their fingers to be burning in the pot.

If you can't beat 'em, join 'em … banks that aren't getting their fingers in the fintech pie will lose out when it comes to building the next generation bank. So these are my four hot technology agendas for 2015 in banking. It's not wearable, it's not the internet of things, and it's not social media, mobile, Apple Pay, Apple Watch or anything else.

Far more fundamental is the back-end digital architecture based upon core systems renewal, cloud and data analytics, and being somehow involved directly in the innovation stream of fintech renewal that's overhauling the old banking system.

That is the agenda I'm working on and, as evidenced by this notable survey, it's the agenda most banks are working upon. Focus on the core – the rest will take care of itself.

Chris Skinner is best known as an independent commentator on the financial markets through thefinanser.com, which has been awarded the Editor's Choice as Best Banking Blog by the Financial Brand. He is chair of the European networking forum the Financial Services Club and author of ten books covering developments in financial services. His most recent book Digital Bank not only outlines the future of digital banking but also draws the path of how to become a digital bank – for both incumbents and new players, which as such makes it a unique and highly inspiring read packed with use cases.

05
STRATEGIC DRIVERS FOR MODERNISATION

5:1 Why invigorate the bank?

Everyone who deals with a bank as a customer would agree that there is always room for improvement in their experience of dealing with the financial provider. From the banks' perspective, making the experience seamless across channels and simpler, faster and more transparent is a perennial goal. Not surprisingly, 96% of respondents agreed that this was an imperative.

Senior leadership at some of the largest banks in the world have recently revealed massive IT architecture modernisation programmes as they have realised the full impact of their disparate, mismatched systems. They are not only holding back business agility and customer service quality, but also leading to IT security risks, operational failures and downtime, and increased incidences of undetected fraud. 85% of respondents agreed or completely agreed that security must be improved for their customers.

Enabling self-service for bank staff and customers was also seen as a major driver by 87% of respondents.

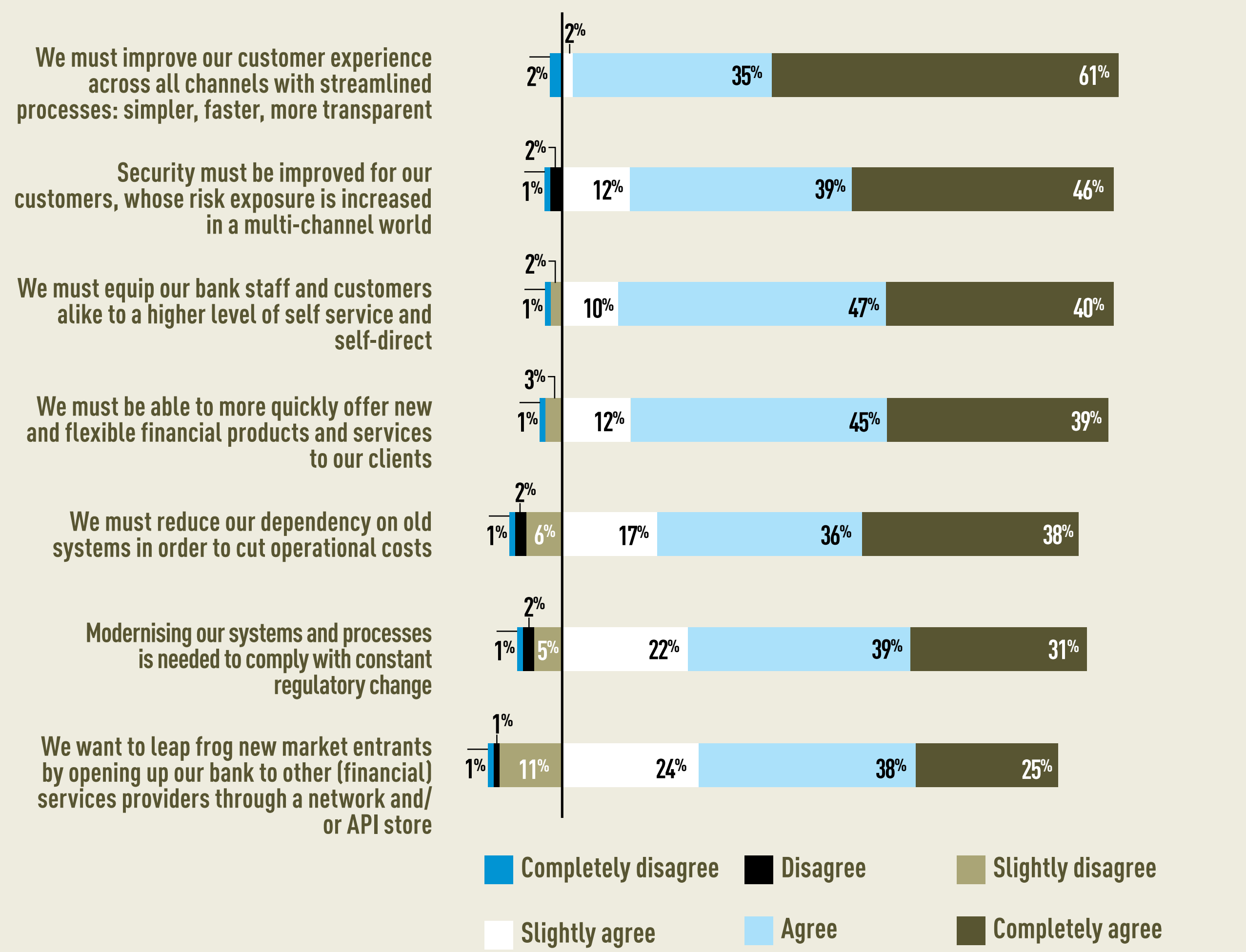
5:2 Cost, regulation and a more open business model

A reduction in cost is also seen as a driver for reducing dependency on older systems, with 74% agreeing or completely agreeing that this is a must. A reduction in ongoing operational costs through a more streamlined and rationalised infrastructure could also free up funds for investing in product, service and channel innovation.

Regulatory change has always been a major initiator of new IT projects within the financial services sector, and business benefits to offset the costs are not always apparent or achievable. These costs are often higher where changes to older, well entrenched systems in the bank are concerned. 70% of total respondents agreed or completely agreed that modernisation was required to achieve effective regulatory compliance on an ongoing basis.

Interestingly, North American respondents were less likely to feel strongly that this is required, with only 41% agreeing or completely agreeing this is required. These dominant drivers for seeking modernisation are familiar, and it is not surprising to see the majority of financial institutions embrace them. But what is more unusual is to see the high number of respondents who agreed or completely agreed that opening their systems to third parties is part of their modernisation agenda, in order to leapfrog new market entrants and act as a wholesale distributor of financial services via a network, market or API approach. 63% of respondents agreed or completely agreed that this is something that they want to do.

fig 3: **STRATEGIC DRIVERS FOR MODERNISATION - WHY INVIGORATE THE BANK? SERVICE QUALITY, SECURITY AND COST REDUCTION DOMINATE REASONS**



Respondents: 126

06
OPINION: B. JOSEPH PINE II

6:1 Beyond "products and services" in banking

If there is one thing the banking survey by Finextra and Five Degrees makes clear, it is that banking is going through a much-needed period of reinvigoration.

And why is this happening now? Of all the questions in the survey, the statement that garnered the most support (98%!) was that "We must improve our customer experience across all channels with streamlined processes: simpler, faster, and more transparent." How true – but let us also recognize, hopefully with something approaching the same level of support, that the customer experience is not just about streamlined processes. It is about creating greater economic value through engagement.

For experiences are a distinct economic offering, as distinct from services as services are from goods. They are memorable events that engage each individual in an inherently personal way. Simpler, faster, and transparent – as important as they are – will never yield more than high-quality "products & services". Instead, we need to go beyond merely improving the old ways to reinvigorate banking by innovating in new experiences. Think of how Umpqua Bank in Oregon, aspiring to be "the world's greatest bank" creates warm, inviting branches that people actually want to hang out and spend time in. Or how ING created the ING Direct Cafes in the United States (now owned and re-branded by Capital One) to expose potential customers to its internet-only bank.

You must, yes, exploit your current knowledge and capabilities to become simpler, faster, and more transparent. But in pursuing a path to reinvigoration, do not neglect reinvention. For you must also explore new competitive spaces, seeking out new experience offerings (even those life- and business-transforming offerings that help your customers achieve their aspirations) that are memorable, engaging, and more customized.

And, finally, you must orchestrate your exploitation and exploration activities, as my colleague Kim Korn puts it, to foster, balance, and integrate them together so that you never again need to reinvigorate your bank, but instead thrive forever.

B. Joseph Pine II is the co-founder of Strategic Horizons LLP and the co-author of, among many other books, The Experience Economy, named one of the top 100 business books of all time. He can be reached at bjp2@StrategicHorizons.com or +1 (330) 995-4680.

07
WHAT DO CUSTOMERS WANT?

7:1 Opinions divided over customer expectations

While there was broad agreement over the financial industry's drivers for modernisation, when it comes to particular areas of customer behaviours and wants, things are not so one-sided. Most agree that customers want simplicity over a rich user experience, with 64% agreeing or completely agreeing. This tallies closely with the 54% who felt strongly that customers prefer an excellent mobile channel over having a branch nearby. Simplicity of user interface and presenting the most used features in an intuitive way are key to a successful mobile channel.

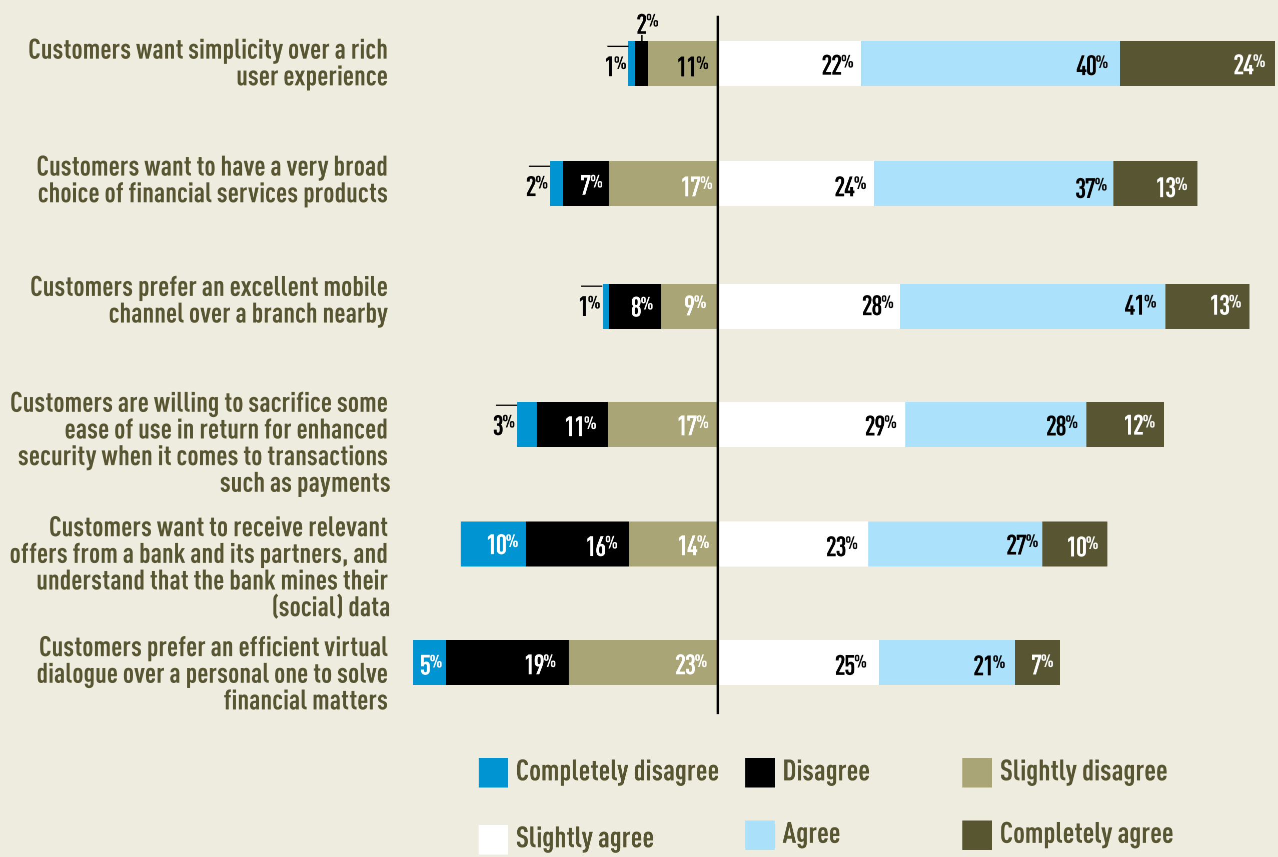
When it comes to product choice, there are some who believe you can have too much of a good thing. Having enough products tailored to meet the needs of all your target customers is no doubt important. But in the retail banking space, having many dozens of cards, loans and account offerings, with only small variations between them, can lead to customer confusion. Many newer entrants to the industry are focussing on fewer high quality products, but this is due to resource constraints as much as a desire for simplicity. For 40% of respondents, predominantly larger traditional institutions, offering a very broad choice of products remains an important part of their customer proposition.

7:2 The personal touch and big data

Where a bank's country, customer demographic and brand values dictate, the preference for pushing customers to engage via personal dialogue with staff, over more self-service virtual interactions, can be a valid business decision. 24% of respondents disagreed or completely disagreed that customers preferred an efficient virtual dialogue. But in some cases, requiring in-person contact can be more of a default position where poor channel design and non-integrated systems mean the bank has no other choice. 28% agreed or completely agreed that an efficient virtual dialogue was preferred.

Whether customers are aware of and comfortable with their data being mined in return for relevant offers from their bank and partners is another area that polarised opinion. 26% disagreed or completely disagreed that customers wanted this. 37% were of the opposite opinion.

fig 4: **WHAT CUSTOMERS WANT - THEY WANT IT ALL**
BANKS AGREE SIMPLICITY AND MOBILE CHANNELS ARE PARAMOUNT



Respondents: 126

08
OPINION: AMIR TABAKOVIC

8:1 Stop guessing and use what you've got: data

We could fill books with the discussions about to what degree customers are rational human beings, where the irrationality kicks in and why and what are the social effects on customer decision making. I will radically shorten this discussion based on our biased beliefs and scientific theories and quote one of my favourite economists W.E. Deming: "In god we trust, everybody else please bring data." So do you use the available data in your bank in the way you should?

State of the art data analysis today supports the decision making process in product definition, product design, marketing, etc. The gut feeling, long experience in business and traditional market research techniques that served us over the past decades are good but no longer good enough. These days customers should decide whether and to what degree they prefer simplicity over rich user experience. They should decide which level of payment security is comfortable for them when they are about to buy say just a cup of coffee. Your job as banks is to provide them meaningful options to choose from.

However, by asking customers what they want you won't get a binary result but a range of different preferences. What is important at one instance may not be at the next. Context is everything. It's time to say good bye to the single customer type. Even customer persona concepts are outdated today. By applying predictive analytics you will be able to provide a new level of personalisation that is linked to events, contexts and situations. You will have to disintegrate the existing products and let them be that what each and every customer expects them to be – a perfect solution for their problem. We must decouple the solution from the rigid grip of the 'product' definition as we know it today. Larry Page, Google cofounder has said, "The perfect search engine understands exactly what you mean and gives you exactly what you want." This should be the benchmark for financial services too.

Get ready for a new age of data products based on predictive analytics. There is a grab bag full of business cases on the customer side but as well on the back office side: card-like offers based on customer spending behaviour, fraud detection based on anomaly detection, client advisory with the help of artificial intelligence and natural language processing and many more. Let us embrace disruptions as a business opportunity rather than a threat that is to be attacked and defeated.

Amir Tabakovic is a banker focusing on innovation with PostFinance in Switzerland and leads the workgroup on predictive analytics at the renowned industry platform MobeyForum.

09 ROAD BLOCKS TO PROGRESS

9:1 Cross-group ownership and boardroom buy-in required

43% of respondents say they've found it hard to get boardroom sponsorship and agreement across business, IT and strategy groups to pursue a modernisation agenda. And 40% are sure that their bank lacks the strategic modernisation plan or digital road map that embraces both the business and the IT infrastructure. Across both of these answers most respondents who answered this way had mid-to-senior level management roles responsible for product, channels and IT.

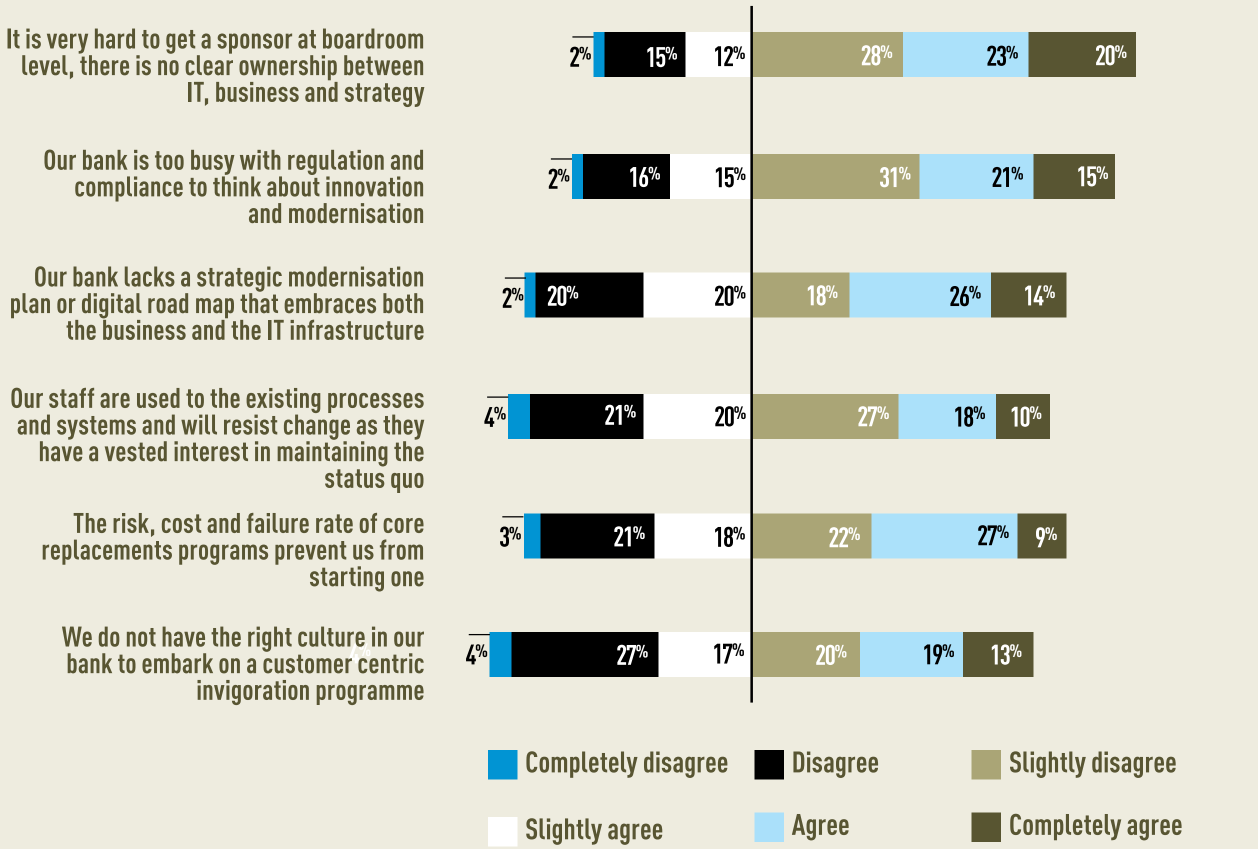
In section 3:2 we saw that 61% of respondents agreed that their business would need a core system replacement within three to five years. But here we see that 36% of all respondents agree or completely agree the risk, cost and failure rate of core replacement programs as preventing them from undertaking such a project. Around half of all those who agreed there was a need also said they are prevented from meeting this need.

9:2 Costs are unavoidable, but what about risk of failure?

Everyone knows that large complex projects come at significant cost. But what causes the risk and failure rate associated with such projects? A comprehensive answer is beyond the remit of this survey, but the number of respondents citing risk and failure correlates very closely with those who bemoaned lack of group-wide strategy and high-level cooperation and sponsorship.

Respondents had more faith in their organisations when it came to whether they thought their corporate culture was a good fit for embracing a customer-centric invigoration program. But it was a close call. 32% agreed that they did not have the right culture in place, while 31% disagreed and said they did.

fig 5: WHAT HOLDS YOU BACK? LACK OF COHESIVE STRATEGY AND COMPLIANCE OVERHEAD CAUSE BLOCKAGES



Respondents: 126

10
NEW ENTRANTS AND THE ESTABLISHMENT

10:1 Threat or encouragement?

On the one hand there was broad agreement that new market entrants are a positive thing for the industry, and by inference customers, as they help to keep traditional players focussed. 69% agree that this is beneficial. But 48% of respondents also strongly believe that new market entrants can be a threat, and that established, well liked brands moving into financial services could easily steal the next generation of customers.

This is not a short-term threat for most banks, where revenue and profit comes mostly from an Gen X and older who are used to, or at least remember, relying only traditional banks to handle their financial services needs. But those banks with a long-term view on demographic and disruptive digital trends are right to be concerned.

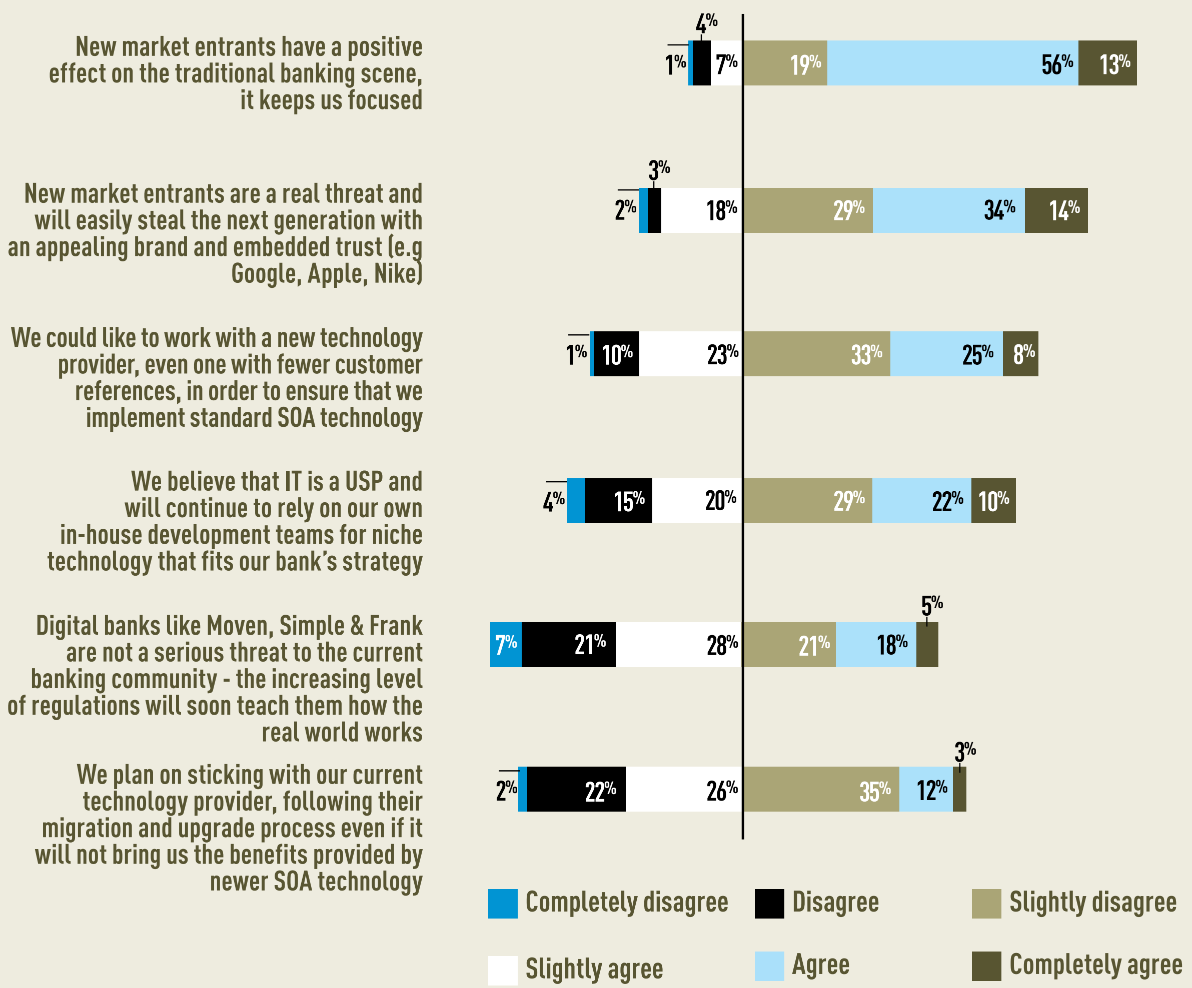
The threat is not only from established brands either. When questioned about brand new start-ups trying to shake up banking, such as Moven, Simple and Frank, only 23% of respondents were certain that regulatory realities would hinder their ability to gain wider traction and compete. 28% disagreed or completely disagreed with this prediction.

10:2 The value of IT and partnerships

To stay ahead of the competitive threats and retain and attract customers, not all banks feel that having their own IT development teams and niche technology is required. 19% feel their IT is not a unique service proposition, compared to 32% who do. Those who don't place this value on having in-house development, and by inference already rely more on packaged software and external providers, are strangely less likely to feel tied to an external provider. Only 15% would continue upgrading with a technology partner that didn't provide standard server-oriented architecture (SOA) technology. This compared to 33% of all respondents.

Customer references are an important part of the vendor vetting process when selecting new IT partners. But they are just one factor among many. 33% of respondents agreed or completely agreed that they would like to work with a new technology provider, even one with fewer customer references, in order to implement standard SOA technology.

fig 6: **NEW ENTRANTS AND THE ESTABLISHMENT DISRUPTIVE COMPETITION FORCES BANK RESPONSE**



Respondents: 126

Finextra Research Ltd
101 St Martin's Lane
London
WC2N 4AZ
United Kingdom

Telephone
+44 (0)20 3100 3670

Email
contact@finextra.com

Web
www.finextra.com