The shifting nexus of retail banking

As customer relationships become transaction-based and as more players compete for revenue, legacy institutions will have to double down on experience and trust.
The origins of our modern banking system can be traced back almost 800 years to the Italian city-states of the medieval period, when moneylenders would negotiate with merchants or farmers and record their transactions while sitting at benches, or bancas, from which the modern word bank is derived. At the time, each transaction — usually the extension of a credit line — was negotiated between a creditor and a client and tailored to the specific needs of that individual in that moment. The transaction was the heart of the banking relationship.

Over time, however, as the scale of banking operations increased, it became necessary to create a more efficient way of managing multiple transactions, and so the bank account emerged. As banks shifted their attention from the transaction to the account, in the interest of scaling efficiently, they also increased the level of standardization in individual transactions to minimize the effort and costs required to manage each account.

Fast-forward to the turn of the 21st century, and the fundamentals of consumer banking remained largely unchanged. The primary function of a bank was providing a store of value in the form of either a deposit account or a fixed line of credit that could be drawn down as required. The foremost responsibility of financial-services providers operating within this paradigm was to manage these accounts prudently and efficiently, and it was this ability that enabled a bank to compete in the market. Within this model, though, transaction execution was largely a secondary consideration. Consumers were limited to a few ways of accessing funds, and there was little differentiation among providers.

In the past few years, however, that dynamic has begun to change. For the
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first time in centuries, we’re starting to see customers making choices based on transaction execution. And instead of simply choosing a transaction method from the options provided with their particular account, they are adapting where they store their money — or how and from whom they borrow — to suit their preferred way of paying for goods and services.

The result of this shift is that the customer relationship is tested and challenged with each transaction, and is therefore up for grabs every time a person makes a payment. And it’s no longer just banks and traditional payment companies that are competing with one another for a slice of the revenue pie: Big tech and emerging tech companies are now vying for business, too.

Given this new competitive dimension — call it the transaction experience — it becomes clearer by the day that if banks are to survive, they’ll need to redesign the core of their relationship with the customer, delivering personalized user journeys optimized for the ways in which customers want to transact. And crucially, they’ll need to capitalize on one asset that usurpers can’t match: the public’s trust. Building on that trust, they can then become the creators and shepherds of digital identity, creating for themselves a permanent foothold in the new transactional banking model.

**The coming banking revolution**

For the clearest examples of what the future of retail banking will be, it’s perhaps most informative to look beyond the relatively settled developed markets and consider the dynamic consumer banking landscapes of China and India.
In China, Alipay and WeChat Pay began as a means for people to transact quickly, conveniently, and securely within those respective ecosystems. But as people became accustomed to these online payment systems, the services grew and evolved. They have now displaced banks as the primary way in which many Chinese consumers (and merchants) receive their wages or salary, store and invest their wealth, send money to friends and family, and originate loans. This trend has turned their parent companies (Ant Financial for Alipay and Tencent for WeChat Pay) and affiliated banking arms into some of the world’s largest fintechs, with lending books and assets under management that rival some of the West’s most prestigious banks and asset managers.

India has seen a similar trend, aided by the Indian government’s proactive approach to stimulating the electronic payments sector. One outstanding example of those taking advantage of the nation’s innovative payments infrastructure is Paytm, a business started in 2010 with a set of relatively simple use cases around making payments easier and more convenient. Like its Chinese counterparts, Paytm has quickly expanded from this foothold, using payments as a stepping-stone to provide its approximately 400 million users with a host of other services that in the West would ordinarily be provided by a bank, credit card issuer, or asset manager.

Another example — perhaps more recognizable to Western consumers — is the Indian equivalent of Google Pay. In 2018, the tech giant announced it had partnered with a panel of Indian banks to provide consumer loans directly through the Google Pay app, creating an exceptionally quick and convenient alternative to credit cards. And in June 2020, Google announced it would be adding small business loans to its offerings, accessed through its Google Pay for Business app.

This trend toward payments acting as a gateway to establishing wider banking relationships is more obvious in developing markets, but similar examples exist in the West. Since the launch of PayPal Credit, for example, the payment provider has bridged the gap to consumer lending with great success. The company recently announced it has originated more than US$50 billion of lending in the U.S. — lending that would traditionally have been provided via credit cards and overdrafts.
Similarly, buy-now-pay-later businesses such as Affirm in North America, Klarna in Europe, and Afterpay in Australasia have quickly grabbed a significant — and growing — share of the consumer lending market by offering a form of lending, integrated into the online checkout process, that is tailored to the way consumers prefer to transact rather than being predicated on an account-based relationship. Shopify also recently announced that it will begin offering installment plans as a payment option to hundreds of thousands of retailers on its platform, and Goldman Sachs has thrown its hat into the ring with Marcus-Pay; it seems clear that this trend toward digital point-of-sale financing is likely to continue.

And it’s not just in lending where the importance of each individual transaction as a potential bridge to customer relationships is growing. In the U.K., for example, two of the most popular fintech innovators, Revolut and Monzo, first drew in customers using innovative payments propositions before eventually obtaining banking licenses and expanding into current accounts and lending. With these “neo-banks” having just crossed the Atlantic, it’s only a matter of time before the major U.S. banks also start feeling their impact.

Even more potentially disruptive is that the likes of Google Pay, Apple Pay, and Amazon Pay have been intermediating an ever-increasing share of not only online payments but also in-person transactions. The combination of the almost ubiquitous adoption of smartphones, biometric ID verification, and near field communication checkout terminals have made mobile wallets a more convenient and secure form of payment than traditional debit and credit cards. Because
they’re contactless, mobile wallets are ultimately safer, too, especially in the context of COVID-19. And as the pandemic restrictions drive a dramatic upswing in online transactions (while discouraging the use of both cash and card-based payments), the gradual trickle of consumers toward payment methods controlled by big tech platforms has turned into a torrent.

The regional outsiders (in China and India), the scope outsiders (fintech start-ups), and the industry outsiders (big tech) are all making it clear that innovation in transaction execution is becoming the defining competitive dimension in the consumer banking sector. But the West’s financial-services powerhouses have, for the most part, been slow to respond. Banks have lost sight of the full range of dimensions of value they deliver to the customer; it could be argued that their efforts to achieve economies of scale have pushed them to over-standardize. They may be yet another legacy industry that has fallen behind and lost sight of a broader wave of transformation, in which the ongoing trend across industries and markets is to personalize offerings (albeit at a mass scale) and embed them within broader ecosystems. At this point, banks are well behind in this game.

**Why banks need to worry — and act**

For now, the change in priorities among banking customers might not seem like a major issue for the sector as a whole. Regardless of the actual payment mechanism, funds continue to flow from traditional accounts that banks control through the major card networks with which they’ve partnered. The big tech platform providers also have been relatively restrained in making their presence felt financially. The charges that Google and Apple impose on the banks that connect to their payment wallets range from nothing to a fraction of a percentage point. So far, the platforms have also refrained from attempting to install themselves as a primary means of storing funds or offering credit in the way their Chinese counterparts have.

Despite this benevolence, however, traditional financial institutions are in a precarious position of their own making. Without really putting up a fight, or perhaps without even realizing it was happening, they’ve effectively ceded control over the consumer payments landscape to big tech platforms. The volume of transactions that take place within environments controlled by the tech giants is
now so great that they — not payments companies, much less banks — are the ones calling the shots.

The real danger is that as the nexus of the banking relationship continues shifting toward transaction execution, banks will also cede control over the thing that really matters most in retail banking: the consumer balance sheet.

If this happens, traditional financial institutions risk losing out on all of the revenue streams associated with transactional consumer banking — encompassing not only payments and unsecured lending revenue but also account fees, foreign exchange revenue, and cash handling fees — and the valuable transaction data that accompanies these revenue streams. And they risk losing access to the cheap source of funds that checking (or current) accounts afford them, jeopardizing the very foundations of the traditional retail banking model.

**Adapting to the new reality**

As the focus of banking relationships shifts from accounts to transactions, the old ways of competing are likely to become less and less relevant. But if the battleground has moved, why is it that strategies are still not changing? And what will it take for banks to evolve with the times?

The first step for banks that want to make progress in this new world is for them to acknowledge and accept that, contrary to the received wisdom of years past, winning and owning the checking account relationship will no longer be a sure recipe for capturing value. In the past, the checking account acted as the gateway to a variety of income streams (spanning both payments and lending), but this convention is already being challenged. In the future, that revenue will instead flow to tech-savvy interlopers who interject themselves at the point of transaction with a slicker, more user-friendly alternative.

And it’s not just the obvious culprits — Apple, Google, Amazon, Facebook, and Uber — that are responsible for this change. Think also of specialists, such as Zelle or Venmo for peer-to-peer payments; Transferwise or Revolut for international transfers; the aforementioned Klarna, Affirm, and Afterpay for lending at the point of sale; and the as-yet-unknown innovators set to disrupt Mastercard’s and Visa’s dominance, as open-banking–enabled, direct-to-account payments become commonplace.
The future of retail banking will require that institutions engage in a broader ecosystem.

In the old world, consumers cared most about the trustworthiness and security of an institution, combined with its ability to offer the most attractive rates on deposits and lending. In the new world, the key modalities of competition will be the trustworthiness and security of transactions, along with the speed and accuracy with which they are executed, and the fairness and transparency of pricing. Because of how easy it will be for consumers to compare rates, the ability to differentiate on price for both deposits and lending will largely be competed away.

Banks will also need to recognize that the moments of truth when customer relationships will be on the line will be happening with such frequency — with every transaction — that it will become more important than ever to eliminate any unnecessary friction in the customer experience. So, too, will it be important to intercede at the perfect moment with a tailored offer that surprises and delights. And given the ongoing migration of commercial activity to digital platforms, this will inevitably mean being present within and seamlessly integrated into the payments layer of the digital economy. The future of retail banking will require that institutions engage in a broader ecosystem (bank, customer, and platform), and the value they are able to create will depend upon collaboration among these multiple parties. Access and partnerships will become even more important than they already were, and embracing interoperability — the ability to integrate with platform providers in a seamless and flexible way — will be vital. For example, banks can remove the traditional distinctions between a credit card, overdraft, and personal loan, and instead deal in fungible lines of credit that can be accessed through a variety of platform interfaces.
One or two of the more forward-thinking banks already have begun to make the transition. In the U.S., for example, Goldman Sachs — for so long the gold standard in investment banking — is positioning itself for success in the retail space through its partnership with Apple to deliver the Apple credit card. Citibank has hinted at its future plans through its partnership with Google, which was revealed late in 2019, and Uber’s partnerships with Green Dot and Barclays provide both these banks with an avenue for ensuring their ongoing relevance.

It’s noteworthy that in each of these instances the big tech companies have opted for partnering with just one or two companies, rather than opening their platforms to multiple financial providers. Amazon, for example, reportedly considered partnering with a selection of lenders for its new small and medium-sized enterprise lending business before ultimately opting for an exclusive relationship with Goldman Sachs. This contrasts with Google’s strategy in India, where the company works with a panel of four lenders that are accessed through the Google Pay app.

Regardless of whether these relationships evolve as bilateral or multilateral, the lesson today is the same: If banks are to even be considered for a seat at the table, interoperability will be a fundamental requirement.

The winners are likely to be those that work collaboratively with platform providers — and pull in additional data providers, fintechs, and other third parties — to co-create solutions that make consumers’ lives simpler and their user experiences more coherent.

Crucially, participation in these multilateral ecosystems will mean managing not just monetary flows, but also data flows. And it’s this point that offers some hope for traditional banks to not only retain their current relevance, but perhaps make themselves indispensable.

**The role of trust and the importance of consent**

Given big tech firms’ seemingly insurmountable advantage over banks in terms of technology and reach, one might question why they haven’t already overrun the financial-services sector. The main answer, at least for now, is regulation. And although banks and other regulated financial institutions carry a heavy cost in ensuring they remain compliant, their practiced ability to adhere to strict regulation
Identity and consent are fundamental to not only banking, but to all manner of commercial arrangements.

imbues them with another important earned asset over and above a license to operate: the public’s trust. This is a commodity that’s becoming more valuable as personal data rights come under increasing public and government scrutiny, and it’s something that may ultimately prove pivotal to the banking sector’s future.

It’s difficult to overstate the importance of trust to the financial and economic system. And yet, the value of the trust created by banking’s highly regulated environment has apparently been overlooked by the very banks that commit so much money and resources to fulfilling regulatory requirements. Those banks have so far missed a prime opportunity to harness trust and use it to unlock further innovation across the digital economy and ensure banks retain a central position within it. One way for them to do that is by creating an accessible, secure, and reliable means of verifying a customer’s identity, as a necessary precursor to that customer consenting to an interaction.

Identity and consent are fundamental to not only banking, but to all manner of commercial arrangements. They are vital to each and every sale, purchase, contract, and authorization — to every economic relationship and every transaction. In the absence of trusted forms of identity and consent, commerce becomes more costly and time-consuming, and the risks of theft and fraud multiply.

In most developed countries, however, there’s currently no agreed-upon standard for digital identity. Instead, various entities both public and private — banks among them — have their own unique verification processes, often involving cumbersome two-factor authentication methods. As Europe has demonstrated through its experience with strong customer authentication (the rules requiring
customers to take additional steps to approve some online and contactless transactions), these methods are frequently both costly to implement and detrimental to good customer experiences.

The sorts of disconnected journeys that users must endure just to get credentialed are likely to become a major sticking point as the economy shifts ever further toward digital platforms. Customers and platform providers will both demand that verification and consent processes be instant, integrated, and frictionless. The only way to make this a reality will be to create a universally recognized and accepted form of digital identification.

As a result, banks are uniquely positioned to embed themselves as an essential feature of the digital economy. They can become custodians of identity and consent — and, ultimately, of trust.

**Digital identity as a key differentiating capability**

In all developed markets, the major clearing banks have already verified identities and conducted due diligence for anyone who holds a bank account (in other words, for the overwhelming majority of the adult population). And unlike governments — which might only verify their citizens’ identities once per election cycle or when a passport or driver’s license is up for renewal — banks and their customers are mutually invested in keeping this information secure and up-to-date as a means of protecting against financial crime.

Banks also already have the robust onboarding practices needed to verify the identities of new customers and conduct the know-your-customer checks required to maintain the integrity of the banking system. Furthermore, and importantly, although consumers might not typically like the banking sector, they do generally trust it to manage their data in a safe and responsible way (increasingly a key differentiator from big tech firms).

To retain their relevance, therefore, all banks should make it a priority to seize on this unique capability and create a form of federated bank ID that is recognized and accepted throughout the digital economy. This ID would form the basis of consent in the online environment and become the means by which consumers can securely and consistently sign up for services, apply for products, authorize transactions, and grant access to their banking data.
Implemented in the right way, such a solution would provide mutual benefit across the financial-services sector. At the very least, it could assist banks by eliminating the cost of developing proprietary systems or processes, reducing losses associated with fraud, and helping overcome design challenges inherent within their user journeys. And with sufficient adoption, digital bank IDs could be used in a vast array of applications throughout the digital economy, becoming a supplementary source of revenue to participating banks (as they already have for several Nordic banks).

But even more importantly, by tying digital identity to a bank account, banks can ensure that these accounts retain their centrality within the financial ecosystem — both online and offline. When a bank account effectively doubles as a digital passport, the cost to consumers of abandoning the traditional banking system for a tech-led alternative will increase immeasurably.

BankID in Sweden provides a vivid illustration of a federated digital identity program’s potential contribution to the digital economy and, crucially, to keeping banks at the heart of it. Launched in 2003 by a consortium of Sweden’s major banks, BankID has been adopted by more than 99 percent of Sweden’s working-age population. Most Swedes use BankID daily to be credentialed with various financial institutions, private companies, and local and national government agencies. Furthermore, BankID has significantly reduced compliance costs, and the variety of use cases supported by BankID has helped cultivate what may well be the most vibrant and innovative financial-services ecosystem in the developed world.

A call to action for the banking sector

Even as they struggle to deal with the impact of COVID-19, now is the critical time for banks across North America, Europe, and Australasia to chart their future and figure out how they will compete. Measuring the experiences of customers, employees, and leaders is imperative as banks embark on this endeavor. The concept of return on experience (ROX), for instance, systematically connects customer, employee, and leadership experience to drive and amplify value for the business.

The shift from an account-centric to a transaction-centric paradigm is
challenging traditional notions of the banking relationship. At the same time, the rise of platforms and their growing dominance within the digital economy are having wide-ranging effects on the competitive landscape.

To stand any chance, banks need to adapt to the new reality and embrace an ecosystem approach to value creation. Partners will value those with the ability to create simple, coherent journeys tailored to each user. Interoperability will be the name of the game — and security will be the table stakes.

Even banks that rise to these challenges could yet find themselves displaced, however, if they do not harness the one thing that truly sets them apart from the giants of the technology sector: trust. They must thus set aside their own proprietary identity, verification, and consent solutions, and start collaborating toward a common, industry-wide standard.

Banks have a small window of opportunity to emulate the Nordic example and take ownership of digital identity, thereby ensuring an unassailable position in the digital economy. As the nexus of the consumer banking relationship continues its migration away from the traditional stores of value and toward the platforms where transactions are executed, federated digital identity could be a decisive factor in banks’ continuing fight for relevance — and indeed in their survival.