The future of banking: challenges and strategies for digital and traditional banks

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Navigating the shifting landscape for financial institutions will require collaboration and a willingness to capitalize on the unique strengths of both incumbents and newcomers.

The banking industry is undergoing a profound transformation. Although technology has long played a part in altering the financial landscape, including the "Internet banking" days claiming the end of branches, never before has the pace accelerated like it has over the past few years. And now, GenAI is making the environment even more complex.

In this context, digital banks are disrupting the traditional financial landscape with innovative, customer-centric solutions. Despite some failures, new players are successfully entering the market, including KakaoBank in Korea, while others are on the verge of turning profitable or have already become so, including GXS Bank and Trust Bank in Singapore.

Meanwhile, traditional banks have not been sitting still, despite being under mounting pressure to adapt, keep up with customer expectations, and defend their turf. For example, earlier this year, Trust Bank announced that it now has a million customers in Singapore, which has a population of 5.6 million people.

Digital and traditional banks are both facing a challenging road ahead. Their survival—and their success—will depend on how well they can navigate this shifting landscape.

The ongoing challenges for digital banks

The concept for a digital bank has always been logical: a clean tech stack (and hence lower costs) with no costly branch network, an ability to quickly build an ecosystem of partnerships, and importantly, innovative enough to meet consumers' evolving needs with compelling propositions. However, the results haven't always followed. As it turns out, customers are very loyal to their traditional banks, and they trust them more than they do digital banks.

Regulatory restrictions have also been challenging. For example, digital banks in Singapore can only take a limited amount of deposits and must prove they can become profitable. Such regulations are understandable given the potential risks and disruptions if a bank throws in the towel, as Volt did in Australia.

Even more significant has been the speed by which incumbent banks have been able to catch up. Mandiri's Livin' app, for instance, was able to compete with the same offerings as new digital banks within just two years. Singapore's traditional banks have also limited how much digital banks were able to differentiate themselves, pushing out strong app upgrades with an effective user experience.

Although these incumbent banks do have to deal with their costly legacy systems, many were able to capitalize on their scale advantages by investing and move quickly to close the window of opportunity for digital banks to make their mark.

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Four hurdles for digital banks to clear

To compete with traditional banks, digital banks will need to overcome four challenges:

1. Customer acquisition and trust

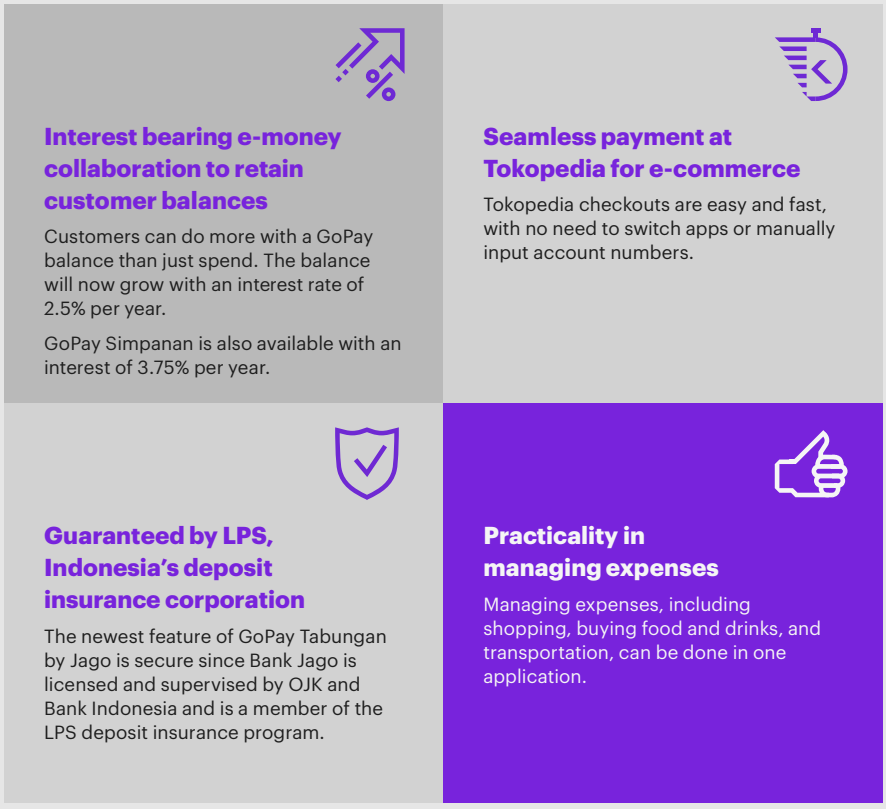
Unlike traditional banks, which have established reputations, digital banks must build trust from scratch. Many consumers are hesitant to make significant deposits with a fully digital institution because of concerns about security, service reliability, and fraud. When phishing scams affected hundreds of OCBC customers in Singapore in 2022, the bank chose to compensate them. Even though the bank was not at fault, OCBC had the financial muscle to make goodwill payouts to cover what customers lost. And of course, the bank had a wealth of experience and sizable investments to defend against other scams and frauds.

For digital banks, gaining credibility requires strong branding, superior customer service, and regulatory compliance, right from the start. Overcoming trust issues will require prioritizing security, regulatory compliance, and customer transparency. Strong cybersecurity, fraud protection, and clear communication about data privacy can enhance consumer confidence. And to win over new customers, superior service means taking every complaint and all feedback seriously as valuable input to improve.

Aside from credibility, offering everyday services that become the anchor for transactions is essential to retaining deposits at a low cost. Failing to do so often results in unsustainable costs and a very high flight risk, as pricing becomes the sole reason for customers to maintain their balance. For example, comparing an Indonesian digital bank that has a strong ecosystem of strategic partnerships for ride hailing, food delivery, and e-commerce (Bank Jago with Gojek X Tokopedia) with another bank that has fewer lifestyle-related partnerships (Bank Neo Commerce) reveals a distinct trajectory in their deposit and cost-of-funds situations (see figure 1 below and figure 2 on page 3).

Figure 1

Bank Jago's latest value propositions leverage the various ecosystems built by its GoTo partnership

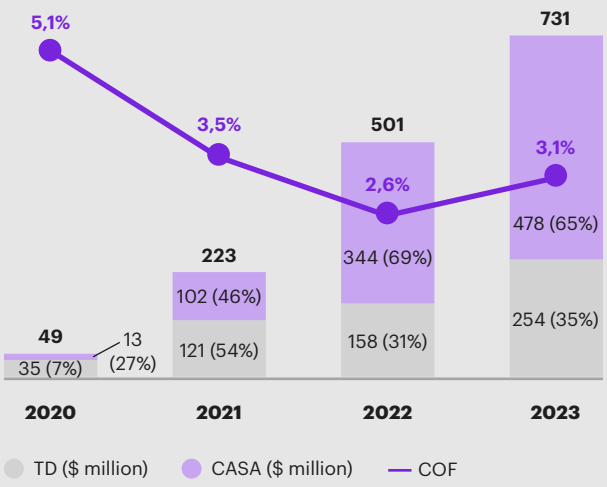


Sources: Bank Jago; Kearney analysis

Figure 2

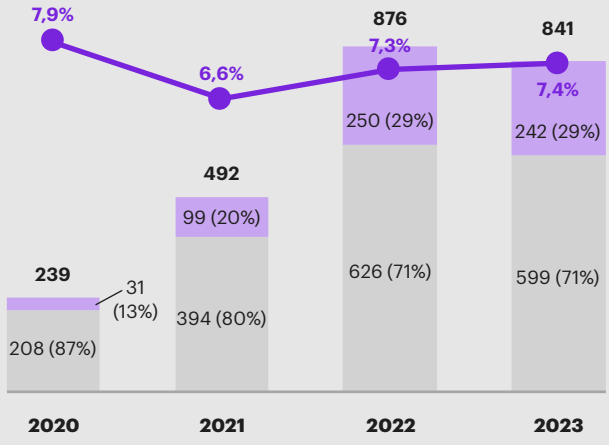
Digital banks with distinct value propositions leveraging an ecosystem play can capture more sustainable customer deposits

Bank Jago deposit breakdown



Deposit and COF: healthy CASA ratio >65% with ~3% COF

Bank Neo Commerce deposit breakdown



Deposit and COF: dominated by TD of >70% with >7% COF

Notes: COF is cost of fund; CASA is current account savings account; TD is total deposits.
Sources: banks' financial statements; Kearney analysis

2. Profitability and sustainable business models

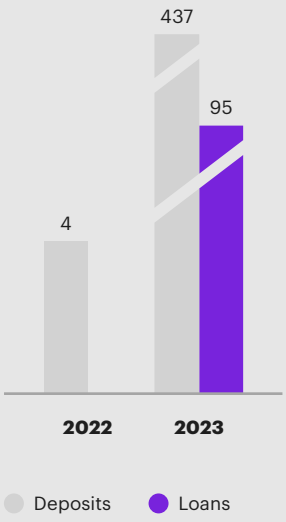
Despite rapid growth, many digital banks struggle with profitability. Their primary revenue sources—interchange fees from card transactions and lending—often fall short of covering their high customer acquisition costs, technology investments, and compliance expenses. Unlike traditional banks, which generate income from a wide range of financial products, digital banks must find ways to do two things in particular: quickly scale up lending while also constantly improving underwriting models using varied data. And yet the two are at odds: how can a bank be agile and lend quickly against the risks without worrying about default spikes? It's not easy, but for growing markets, targeted segmentation can sharpen the focus (see figures 3 and 4 on page 4).

And once the target segment needs are clear, digital banks gain a foothold with new customers before traditional banks set up a stronger defense by tailoring products (such as for small businesses that can't get financing from traditional banks and providing financing tools such as expense tracking) and having innovative offerings such as wealth management services with robo-advisors and investment platforms. In Singapore, platforms such as Arta and Endowus seem to be making headway in emerging affluent segments that aren't properly served—or given enough attention—by local banks.

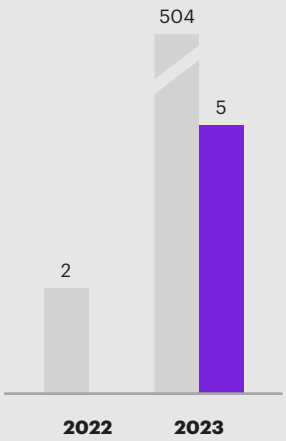
Figure 3

Singapore's digital banking landscape is expanding rapidly thanks to deposit growth while facing challenges to build quality loan books just as quickly

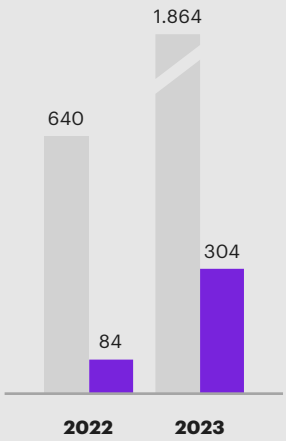
GSX deposit x loan growth (million SGD)



MariBank deposit x loan growth (million SGD)



Trust Bank deposit x loan growth (million SGD)



Highlights

Each of these Singapore digital banks started operating in 2022.

Each focuses on retail customers and has a well-built ecosystem play:

- GSX: Grab and Singtel
- MariBank: Sea Group
- Trust Bank: Standard Chartered and FairPrice

All three have grown their deposit base quickly via interest rates and various promotions. Meanwhile, loan growth takes more time because of challenges such as underwriting capabilities and finding the right segment and product match.

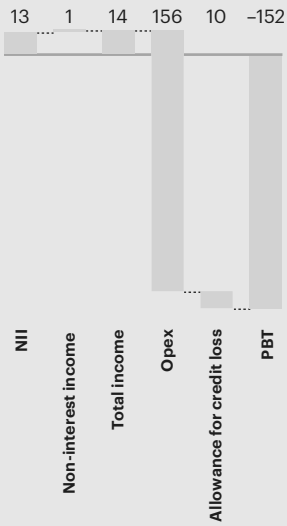
Note: SGD is Singapore dollars.

Sources: banks' financial statements; Kearney analysis

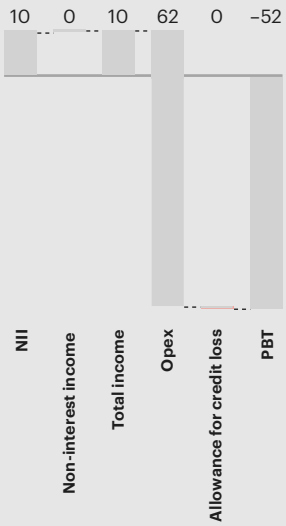
Figure 4

Two years in, digital banking profitability remains a challenge and will likely take a few more years to materialize, especially in a mature market such as Singapore

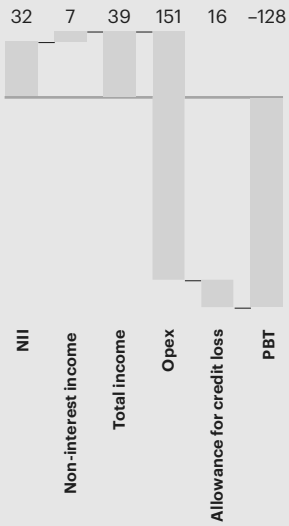
GSX P&L 2023 (million SGD)



MariBank P&L 2023 (million SGD)



Trust Bank P&L 2023 (million SGD)



Highlights

Growing and scaling loans in a mature market such as Singapore is a big challenge, especially with margin pressure in both credit and fee-based income.

Opex growth should taper off after the initial build of the digital banks.

However, allowances and actual credit losses may increase as the banks expand their loans into riskier segments and products, such as small businesses and buy now, pay later offerings.

Note: SGD is Singapore dollars; NII is non-interest income; PBT is profit before tax; P&L is profit and loss.

Sources: banks' financial statements; Kearney analysis

3. Customer retention and monetization

Acquiring customers is one challenge; keeping them engaged and profitable is another. Many digital bank customers treat these platforms as secondary accounts rather than as their primary financial institution. Without a comprehensive range of services, digital banks risk high customer churn and limited monetization opportunities. This is particularly true for digital banks that rely on pricing to attract deposits. This approach leads to an expensive funding segment dominated by high-net-worth individuals who will move their deposits to the next bank for better pricing if they don't find product and service propositions that are relevant for them.

Forward-thinking digital banks are relentlessly focused on using their acquisition dollars wisely. Gone are the days of deep funding pockets. For instance, cash-back gimmicks only go so far. Instead, focus on customer propositions that build loyalty. Trust Bank in Singapore is a good example. The bank offers a card with no foreign exchange fees, broadening the relationship beyond a basic bank account. The user experience is also much better than at incumbent banks.

4. Regulatory hurdles, compliance risks, and stiff competition

As they expand, digital banks are facing more scrutiny from regulators. Compliance with anti-money laundering laws, data protection regulations, and capital requirements adds complexity and cost. In many markets, regulators are still defining how to oversee fully digital banks, leading to uncertainty in operating models. There's no easy way to handle this against the armies that traditional banks deploy, but it's also no place to take a shortcut by underinvesting. Instead, being innovative and using GenAI to experiment—and learning from any mistakes along the way—can help level the playing field, along with managing regulator relationships and partnering with them to address industrywide issues.

Competition from traditional banks and fintech giants isn't abating. Traditional banks are aggressively digitalizing their offerings, capitalizing on their strong reputations and broad base of customers. But they aren't the only competition for digital banks. Fintech giants such as PayPal and Square along with big tech companies such as Apple and Google are entering the financial services market, creating intense competition. What digital banks can do is push hard on the GenAI agenda and data analytics to deliver personalized financial insights and customized savings plans.

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Five ways for traditional banks to come out on top

So how can traditional banks overcome this competitive threat? Five moves stand out.

1. Slim down, and reach out

Begin by addressing the fundamental strength premise of digital banks: no branches and a clean, lower-cost tech stack. Despite branches being much maligned, make the most out of them for customer acquisition. Maintaining large branch networks is costly, especially as digital banking limits the need for in-person interactions. So reassess the physical footprint and focus on "phygital"—combining the best of physical and digital—along with digital-first engagement strategies. Especially in countries where banking penetration is low, use digital strategies to reach unbanked customers in the micro, small, and medium enterprises segments. In urban areas, slim down, do more with less, and make bold moves to migrate to digital channels with minimal current account savings account (CASA) losses.

2. Unshackle from outdated IT systems

Reduce the pain and limitations of traditional IT systems. More IT investments will be required, so align the investments with the overall business strategy and the required capabilities to maximize top-line outcomes. Make the difficult transition from outdated technology to modern cloud-based architectures. Reimagine the insource/outsource models to keep talent and the required capabilities in house. Ultimately, having a well-engineered enterprise architecture will create confidence in multiyear IT spend while staying on target for financial outcomes, such as the cost–income ratio and the return on equity.

3. Combat the "innovativeness" aspects

In many regions, digital banks burst onto the scene saying, "What if we did banking differently?" And in many cases, they trounced traditional banks, especially in customer service and offerings that delight customers. In fact, many incumbent banks are simply failing in this, initially because of hubris and then realizing that playing catch-up takes time. Forward-thinking banks are refocusing on the customer journey and finding ways to build long-term customer loyalty. One good comeback story is Bank Mandiri, which became well-loved by its customers after revamping its Livin' app, making it even more difficult for payment fintechs and newcomer digital banks to dislodge the incumbent.

4. Build on existing relationships

Take advantage of existing relationships, including AI-powered financial advisory services, embedded finance solutions integrated with third-party apps, and cross-border payments, just to name a few. At a minimum, these can strengthen the fortress against newcomers that are pitching similar propositions. YouTrip in Singapore, for example, has gained a significant following on foreign currency transactions with its transparent, low-cost foreign exchange rates, against what otherwise would have gone to credit cards.

5. Take advantage of the latest technology

Use AI and machine learning to offer personalized product recommendations, predictive analytics for financial planning, and tailored customer experiences, capitalizing on the advantage of having more customer data compared with the newcomer digital banks.

The key to success is having the speed to adapt

As customers' needs, the competitive landscape, and technological innovations continue to change rapidly, the future of banking is not a zero-sum game between digital and traditional banks. Have a clear understanding of one's strengths as well as which gaps to plug will be essential to thrive. With today's demanding margin pressures, the case for collaboration will be front and center to optimize competitiveness and continue to define the industry's evolution. Traditional banks bring experience, trust, and financial stability, while digital banks offer agility, innovation, and superior user experiences. And to a degree, convergence is already being seen with digital banks investing more to replicate traditional bank strengths based on trust, while traditional banks have pushed harder on innovation.

So who will succeed? The answer depends on the ability of both digital and traditional banks to adapt, innovate, and find synergies rather than engage in a battle for dominance. Those that embrace change, invest in technology, and prioritize customer-centric strategies will emerge as leaders in their own space.

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