ICBA Payments

Digital Transformation

The Payments Business Model

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Executive Summary

Digital Transformation is an enterprise-led business model that enables banks to respond to the needs of their current and future customers through an organizational strategy established to create digitally delivered products and services.

- Consumers and small businesses are responding to fintech banking services and consumers are picking and choosing services based on specific needs. This dynamic is an opportunity for banks to offer a centralized service that keeps consumers interacting with their brand– something fintechs and retailers are also leveraging in their own payment product strategies.
- The building blocks that support a digital transformation include cloud computing and Application Programing Interfaces (API) platforms, used in place of or to augment existing operating systems. These technologies speed up market entry, reduce overall maintenance, and can enable banks to unlock the value of cross-product customer data.
- As an emerging solution in the U.S. market, open banking services can be viewed as the potential heart of a centralized service. However, these strategies require integration with third parties, which demands a strong governance model and risk management oversight.
- Creating a centralized service with a true digital eco-system requires a deep understanding of the customer journey and how to take friction out of the experience.
- Today, the combination of shared infrastructure, flexible API integration, and embedded finance continue to push the envelope for competitive financial services into new expansion segments, faster than ever. Community banks must accelerate their digital transformations in order to remain competitive and attract the customers of tomorrow.

Introduction

Digital transformation is simultaneously a noun, verb, and adjective. According to Gartner, digital transformation *"...can refer to anything from IT modernization (for example, cloud computing), to digital optimization, to the invention of new digital models."*[1] A Forbes Business Council article defined digital transformation for banks as *"...cultural, organizational, and operational change through technology."*[2] In other words, digital transformation is where strategy, technology, and operations meet to deliver improved value for customers. Yet, it's up to each individual organization to determine what digital transformation means to them, their customers, and how to get there. This is especially true for community banks that face the combined pressures of delivering personal service, a key competitive differentiator, and a modern digital, self-service experience.

Regardless of your definition of digital transformation, it takes time, resources, and capital to get there. This white paper is designed to offer a view of digital transformation from a ground-up perspective, its impact on consumer and small business payments, what the market demand tells us, and where community banks may find transformational opportunities in a sea of possibilities.

1 https://www.gartner.com/en/information-technology/glossary/digital-transformation

2 https://www.forbes.com/sites/forbesbusinesscouncil/2021/12/29/digital-transformation-in-banking-how-to-make-the-change/?sh=586858e36999

Community Banks + Digital Transformation: Current State

Digital transformation is not a stopping-off point, it's a jumping-off point and exists within organizations on a maturity spectrum.

Identifying where your organization lies on this spectrum is key in defining where best to invest in digitally transforming existing operations. The components of that spectrum include:

- The existence, tracking, and monitoring against goals of a strategic roadmap for digital enhancements and additions to existing operational activities.
- The acquisition or allocation of resources and solutions towards digital transformation activities.
- Capital investments in infrastructure that support digital services such as cloud computing, API integration, self-service tools, fraud and risk management, mobile banking applications, and data analysis.
- Enhanced staff training and a communications plan to support in-house use and customer support for digital services.

How well these components have been integrated into an organization indicates its level of digital transformation maturity. Digital transformation maturity is not dependent on the size of the institution, but rather on its ability to objectively assess market opportunities against operational deficiencies and take action through digitizing products, service, and operations. Moreover, the complexity and context of digital transformation has resulted in varying market responses. For example, in a 2022 CSI banking survey, executives cited the least confidence in their ability to attract new customers, undergo digital transformation, and collect and utilize customer data.[3] In our own survey, we found that 29 percent of community banks were evaluating or considering digital transformation

3 *2022 Banking Priorities Executive Report*, CSI

and 20 percent had no current digital transformation plans.[4] These are indicators that the majority of community banks aren't sure about how to capture the opportunity in digital services and inertia remains a barrier to active participation.

Do these factors give fintechs the advantage? According to a recent Cornerstone Advisors consumer survey, on average, 27 percent of consumers have their primary checking account with a digital bank of which 60 percent are banking with PayPal, Chime, or Square's Cash App. Additionally, major retailers like WalMart, Walgreens, and Dollar General Store are offering digital checking accounts through their mobile applications. These alternative financial service providers are pulling customers away from traditional banks and putting more tailored features in front of them to improve acquisition rates.

These factors have driven some banks towards a strategy of creating an entirely new digital brand like Texas National Bank's *Bankers Lender* designed as a bank for bankers. Central Pacific Bank's *Swell* is designed for consumers that want to move money between accounts in real-time. And the transformation of River Valley Bank to *Incredible Bank*, points the way to how community banks can leverage fintech strategies to build a state-of-the-art online bank. These initiatives point to the new trend in banking services that target micro-groups like immigrants, female entrepreneurs, musicians, or businesses that operate on e-commerce sites like Etsy or eBay. Easy access to Banking as a Service (BaaS) infrastructure, virtual card issuance, and digital onboarding contribute to the groundswell of these "pinpoint" bank strategies.

In all, the industry is awash in digital financial services. Consumers are responding by dividing their relationships based on personal financial priorities; in some cases, managing 30 to 40 providers.[5] The good news is that there is real opportunity for community banks to leverage

4 *2021 ICBA Digital Capabilities Survey*

5 https://www.forbes.com/sites/ronshevlin/2021/11/15/americans-shadow-financial-lives-why-banks-dont-know-jack-or-jill/?sh=617a6ee0fe34

their differentiators of trust and relationship banking, while meeting the demand for digital banking. So how do these dynamics play out in the banking customer journey? Let’s find out.

The Customer Journey to Digital Transformation

From onboarding to account funding to problem resolution, consumers want faster interactions and self-service options that take the friction out of the process

Particularly post-pandemic, consumers are expecting their financial service providers to deliver an omni-channel experience most relevant to them. They want convenient payments, like contactless cards or access to credit on demand, such as Buy Now Pay Later (BNPL). Younger consumers are especially comfortable picking and choosing financial services that provide the most benefits to them. Therefore, one of the larger challenges many traditional financial institutions face in attracting and retaining payments account holders is that their business models lack customer-level transparency and centralized data views.

Traditional banking models favor a separation of services by profit center or type, such as debit, credit, investments, or savings. They are often one or two or even three steps away from core datasets. It is difficult and sometimes, not feasible, for a bank that operates like this to maintain a master customer database or view customer data at a macro-level. This is an important gap because in these information silos, what's lost is the context of consumers' overall financial behavior and the ability to connect with them based on personally-relevant activities and life changes. Further, often services offered by banks are pushed out rather than integrated into the customer journey. For example, in Figure 1, The Center for Financial Inclusion maps out a typical customer journey through the loan process, comparing traditional and digital experiences.[6]

6 https://www.centerforfinancialinclusion.org/charting-the-customer-journey-in-the-digital-age

The Customer Journey: Traditional vs. Digital

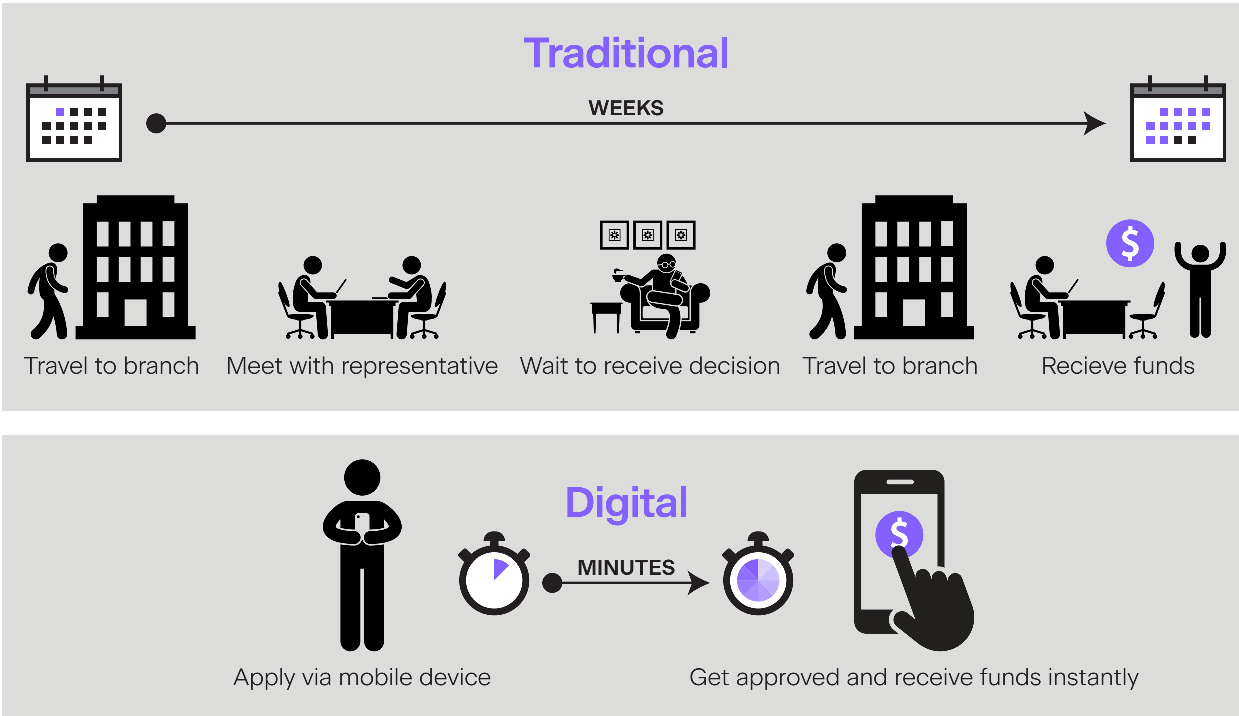

Figure 1

This graphic illustrates one of the problems facing traditional banks—the increased demand for faster processes. Let's take a step back and break this down based on what consumers tell us they're looking for on their journey:

1. **Awareness**—How are consumers made aware of financial services?

   In a recent Morning Consult poll, the majority of U.S. adults recommend financial services they like to others and enjoy learning about financial services from others.[7] Consumers often check in with their network (which includes social media, brand reviews, and personal experiences) as step one in their decisioning. This makes transparent customer service, reviews and ratings, and active online personas key communication channels for banks.

2. **Consideration**—What benefits or features are consumers looking for in financial services?

7 *State of Consumer Banking and Payments*, Morning Consult, Q1 2022

In this step, consumers evaluate service providers based on their personal preferences. This is where hyper-personalization meets demand, but there are other factors that are equally important, such as integration. In a recent EY survey, 53 percent of consumers who banked at local or regional banks in the United States rated seamless integration of other financial providers as extremely or very important.[8] This is where the proliferation of API integration and presenting spending data and analysis along with payment or loan recommendations takes on greater importance in capturing consumers' attention. Don't assume that just because your customers aren't asking for digital capabilities, there is not demand. Chances are that your customers are—or will soon be—meeting their needs for the capabilities in question with other providers.

3. **Purchase**—What is the onboarding experience consumers are seeking?

   Once a purchase decision is made, consumers are ready to open their account. As noted in Figure 1, there can be a wide divide between traditional and digital banks' experiences. Often banks cite their regulatory requirements as barriers to speed, yet a recent survey found that 63 percent of consumers thought banking regulations that required specific documentation were beneficial.[9] In other words, consumers understand that regulations keep data (and money) safer, but it's the way these regulations are incorporated into the process that counts. For example, consumers expect providers to use existing information and offer a consistent process experience regardless of the delivery channel. Moving validation activities to the background can support offering a more seamless experience at point of acquisition and decrease the effort consumers must expend to do business with a bank.

4. **Retention**—Which factors serve to keep consumers engaged?

   The cost of account acquisition is high, and this step is where knowing your customers at a deeper level can translate into lower attrition and higher cross-sell rates for more profitable customers. By enhancing engagement with your brand and effectively leveraging data to anticipate life changes that may present targeted cross-sell opportunities, your

8 https://www.ey.com/en_us/banking-capital-markets/how-can-banks-transform-for-a-new-generation-of-customers

9 *First impressions count—Improving the account opening process for Millennials and digital banking customers*, Val Srinivas, Steve Fromhart, and Urval Goradia, The Center For Financial Services

bank will be top of mind. When this relationship is disconnected or weak, opportunities are lost. According to an Accenture survey, 43 percent of consumers trust their bank to look after their long-term financial well-being, but only 14 percent turned to their bank when a major life event affected their finances.[10] This speaks to the dynamic of consumer expectations that a preferred method of payment will be available when needed. This demand requires banks to support emerging payment types, like instant payments, and then regularly remind consumers of how and where to use them. This approach to proactively serving consumer and small business payment needs can make the difference in preventing them from looking for a new payment provider elsewhere.

5. **Advocacy**—What motivates customers to promote your products?

   Advocacy is where the customer journey circle closes since advocacy feeds awareness. First and foremost, motivating customers to promote your brand means delivering relevant, easy-to-use products. For example, our own data shows that card-not-present (CNP) transactions increased by 26 percent among community bank cardholders.[11] Therefore, enabling features like instant digital card provisioning would be a valuable service for consumers now making purchases without their physical card and could have a positive impact on customer satisfaction.

As an exercise, take one of your products, walk through the customer journey, and critique the experience with an eye towards digital improvement. Pinpointing weaknesses in this way can identify potential roadblocks as you build out a relevant digital transformation roadmap.

10 https://www.accenture.com/us-en/insights/banking/purpose-driven-banking-win-customer-trust

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The Ever-Expanding World of Payments

This faster, technically connected environment favors organizations capable of leveraging their resources and supporting strategies through flexible, more open architectures.

Whether smart home devices, connected-cars, geo-location, or self-checkouts, we are already living in a world of interconnections. In Figure 2, we see how internet technology is rapidly being integrated into the consumer and business experience, requiring solution providers to respond with products and feature sets that fit into a digitally-integrated lifestyle.

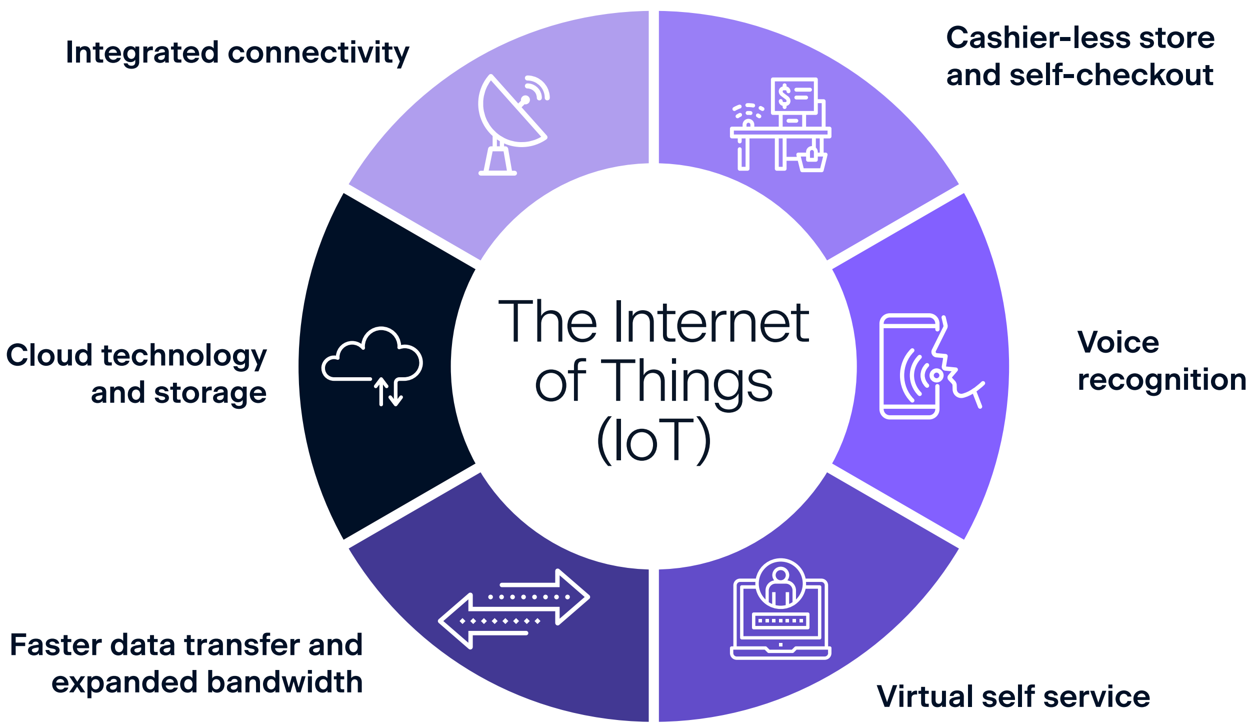

Figure 2: IoT Payment-Related Technologies

As the world of IoT capabilities expands, so too does the move towards digital and contactless payments. The U.S. has had an uneven history with contactless payments, but now that NFC-enabled point of sale (POS) are more broadly operational post-pandemic, issuers are responding. Contactless credit cards are more prevalent than ever with many major issuers, and Visa recently reporting nearly one-fifth of all credit and debit card payments in the U.S. were contactless.[12] Consumers are responding positively to contactless cards because they offer high-value benefits such as speed-to-payment, less physical contact, and more uniformity for international travelers where contactless has been the standard for years.

In McKinsey's annual 2021 Digital Payments Consumer Survey, 82 percent of consumers reported using some form of digital payment across an expanding number of forms including in-app, online, QR code, mobile wallet, wearable, and person-to-person (P2P) transaction types. A key metric that underscores the availability of digital payments is their finding that 15 percent of digital wallet users are leaving their physical wallet home on a regular basis.[13] This indicates that the digital transformation for consumer payments is well underway and is increasing demand for safe, secure digital payments of all kinds.

Another factor supporting digital payments is the improvement in transaction processing infrastructure, like the Federal Reserve's FedNow and The Clearing House's RTP networks along with emerging classes of digital money. Faster payments are eagerly anticipated by small- and medium-sized (SME) businesses as a recent Federal Reserve Study shows. Almost 75 percent of SME's surveyed indicated that support for faster payments will influence their decision to change banks in the future.[14] Early beneficiaries of these dynamics are commercial payment processes, such as supply chain payments, but also cash-replacement payments, like P2P.

With technology playing a key role in developing and deploying these new payment types, the opportunity to get in the game is not only for the largest banks, since banks of all sizes are organizing to leverage new technologies. These technologies are also being used to create a new, emerging class of cryptocurrencies. Cryptocurrency is a generic term for a wide variety of digital money. It can be used to refer to

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12 https://www.bankrate.com/finance/credit-cards/contactless-payments-surge-1-in-5-in-person-payments/

13 https://www.mckinsey.com/industries/financial-services/our-insights/banking-matters/new-trends-in-us-consumer-digital-payments

14 https://fedpaymentsimprovement.org/news/blog/federal-reserve-survey-study-reveals-pandemic-is-spurring-business-demand-for-faster-payments/

decentralized money, like bitcoin, or payments pegged to a reserve asset, like stablecoins. The ICBA is carefully watching this component of the payments market. Learn more at ICBA.org/cryptocurrency.

These new digital stores of value, and the underlying solutions the enable them to be used for payment, can present consumers and small business merchants exciting new opportunities for payment options, even in an uncertain market. However, new payment solutions leveraging digital money, also represent more investment and risk complexity for organizations that must carefully consider the benefit of these emerging capabilities to their market.

New payment technologies have also served to create an entirely new class of on-demand financial services infrastructure, such as banking-as-a-service and credit-cards-as-a-service (XaaS). These technologies, supported by cloud computing and web-based API platforms mean that the competitive market just got a lot bigger. In addition, solutions like Plaid, enable more rapid integration between fintechs and financial institutions. These integration and aggregator services support a wide range of transaction types that require instant access to bank account information for not only monetary transactions, but account verification, balance inquiries, income verification, as well as asset and liability information.

Digital Accelerators and Enablement Opportunities

Accelerators are the building blocks of digital product strategies and can often have a positive effect on margins and create more opportunities for brand engagement and customer loyalty.

Digital accelerators are technologies that allow internal and external synergies through technology. They can include pinpoint solutions, like a streamlined, frictionless password reset processes or enterprise-level initiatives, like moving processes into the cloud. These capabilities support the environments where new digital payments are built-for-purpose such as merchants looking to deepen relationships with their brand, corporations needing to improve controls and increase payment efficiencies, or high-ticket services looking to leverage on-demand credit to boost sales.

An environment (often called a “stack”) that supports digital enablement has unique technical elements that inter-connect with one another to provide the basis, or jumping-off point, for new product development. Figure 3 is an illustration of what a basic fintech-enabled stack looks like and how these services interrelate.

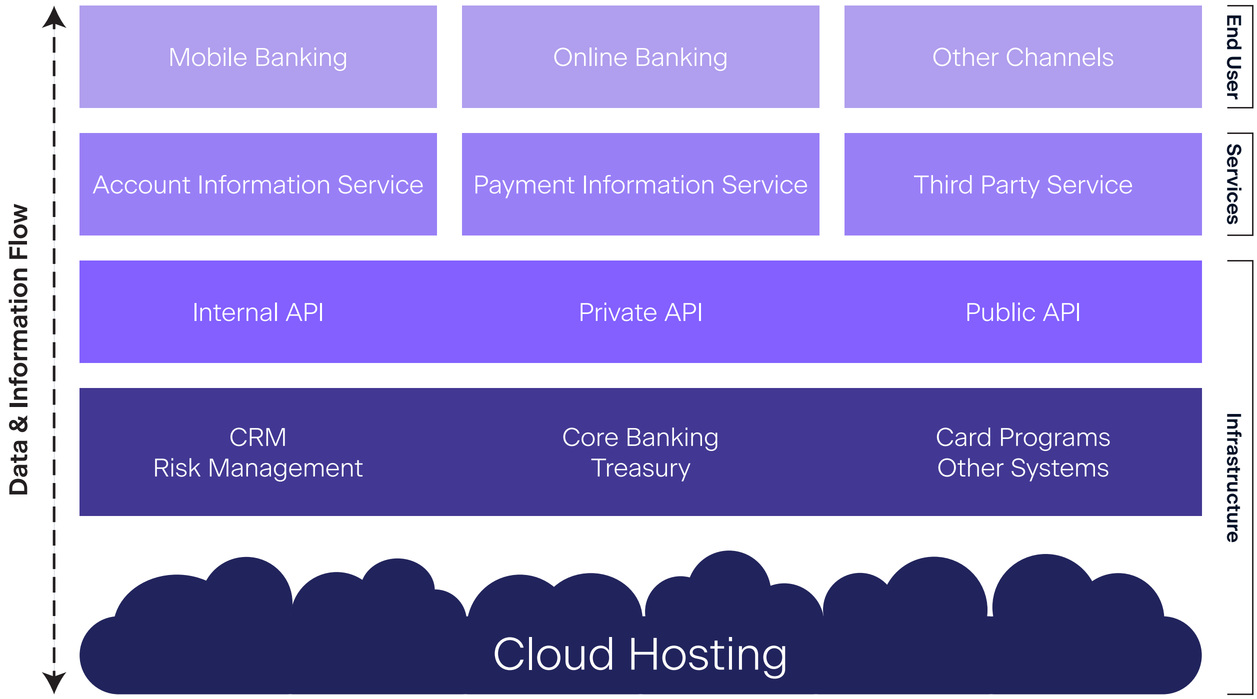

Figure 3: Fintech-Enabled Banking Stack Illustration

Infrastructure

Cloud modernization means enabling services from over the internet rather than using onsite hardware. There are real advantages to cloud-hosted technologies including reduced overhead, faster distribution of services, and access to common datasets. Often, operational resources reallocated from ongoing infrastructure maintenance duties and geographic market expansion or acquisition of new portfolios becomes easier with less middleware. Essentially, moving some or all of your infrastructure to a private cloud or leveraging a third-party's cloud, is an efficiency strategy but there is a near term opportunity cost to implement; such as new integrations, internal processes change management and resource skills, and the design of new data reporting tools.

Application Programing Interfaces (API)

APIs are flexible, integrated connections between systems or their software used to expand capabilities without modifying underlying infrastructure. We benefit from APIs every day. Think about how Google Maps is linked to a business's website to provide location and direction services, for example. For financial institutions, APIs make it easier to link up with other services through digital channels and connect their internal systems to one another, thus providing a robust financial experience for clients. There are several types of APIs for banks including:

- Integration services between internal banking systems (e.g., core banking and CRM)
- Connectivity services between internal and external systems (e.g., Quicken)
- Platform banking services that enable external partners to connect to core systems (e.g., account opening, online banking)
- Product expansion services that allow banks to integrate fintech offerings into their own digital channels

The importance of APIs to digital transformation cannot be understated because they support a wide range of potential new strategies adaptable to many different infrastructure configurations, but more importantly, they help level the playing field for community banks. However, establishing and maintaining API platforms does require expertise in these technologies as well as a security-first governance model to control risk and manage compliance, and an assessment of any cost impacts.

Key Strategies Supported by Digital Transformation

Open Banking

One such strategy increasingly leveraging APIs is open banking; a system designed for third-party access to financial account data. Some U.S. financial institutions have explicitly blocked third parties from accessing their host systems due to concerns about data privacy and security. Despite these concerns, open banking strategies are starting to thrive in the United States because they can provide real value to account holders, including during the account opening process, where previously "locked" data can be used to better assess creditworthiness or determine appropriate credit lines. Open banking platforms also allow banks to enable app integration with pharmacies so consumers can check their HSA balance in real-time without leaving their pharmacy app, for example. These are just a few illustrations of how digital transformation can have an impact on the most common, even mundane, aspects of banking, by providing solutions for operating inefficiencies often hidden.

Account-to-Account Transfers

An important example of how an API infrastructure and governance can create value is with instant payments and account-to-account (A2A) transfers. Consumers expectation of rapid access to funds (i.e., liquidity) combined with more consumers managing multiple accounts, makes A2A capabilities poised to become the next big table stakes service for banks to offer. In a recent Cornerstone Advisors survey of U.S. community banks, the top three use cases for instant payments considered most important were business-to-business (B2B) payments at 54 percent, A2A transfers at 42 percent, and payroll (including expedited) at 36 percent.[15]

15 *What's Going on in Banking 2022*, Cornerstone Advisors

Market Expansion

Leveraging third-party fintech solutions offers another big tranche of potential expansion opportunities for banks, eliminating barriers to market such as development capital and resource restraints. Many fintechs are eager to work with banks that provide attractive distribution opportunities. This kind of win-win environment offers participants real benefits such as gaining access to new market segments, creating new offerings for existing customers, optimizing data usage, and deepening customer product engagement.

As previously noted, when entering into fintech working relationships the bank's strategic growth plans should remain at the forefront. There are a lot of exciting developments in the world of fintech and it's easy to get distracted, so we recommend asking a few basic questions to stay on track:

1. **Time to Market**—can this partner get products into market quickly and safely?
2. **Control**—how much control will the institution have over the end user experience?
3. **Launch Costs**—what do the initial costs look like to integrate and promote the products?
4. **Maintenance Costs**—what are the ongoing costs to maintain the products?
5. **Due Diligence**—is the partner well-funded and able to ensure compliance with all audit requirements, and do its corporate practices align well with the organization?

Super Apps

Once an upgraded, digital infrastructure is in place that supports rapid integration, banks can begin thinking about how to create an application ecosystem for customers. Commonly referred to as a "super app" strategy, this is where myriad services are centralized to meet the needs of specific customers and customer segments. And where cloud technologies and API platforms can be leveraged to help organizations draw from internal or external services to create new products and get them into market quickly. In addition, these technologies offer important digital security capabilities that serve to emphasize the long-standing benefits consumers receive from banks in keeping their data and privacy protected. Therefore, a super-app keeps customers engaged directly with the brand by offering them three key benefits of any competitive payment type: convenience, relevancy, and safety.

Thinking about how a super-app fits into a bank's growth strategy requires a clear line of sight into the target customer journey. This step is where service(s) are defined that anchor the product mix to the customer. From that anchor, banks can identify potential opportunities and prioritize them on the roadmap. For example, small businesses look for services that improve efficiencies through automation, quick access to key business metrics, accounts receivable and payable management, and even payroll and access to short-term credit.

The Market Won't Wait Forever

Payments are now a part of an experience-driven market.

The customer's view of personalized financial services used to mean selecting a special check design or putting a personal photograph on a credit card. Today, the combination of shared infrastructure, flexible API integration, and embedded finance continue to push the envelope for competitive financial services into new expansion segments, faster than ever. Financial institutions that delay addressing the need to modernize their infrastructure to support new payment types, like instant payments, or offer new services like super-apps, run the risk of stalling growth and improving customer retention.

The availability of "X-as-a-Service" solutions have made it easier to get financial services to market faster, cracking open competitive channels for new entrants from across many different segments. These new participants are finding deeper relationships by offering pinpoint payment products and services to their customers. This dynamic is having a fractionalizing effect on the traditional financial institution market, where banks have held sway for hundreds of years. The fintech business model has been established and it is now up to banks to respond proactively and execute against the increasing demand for seamless, digital transactions.

Growing and retaining market share in this kind of environment will depend on a few key factors:

1. **A clear line of sight into target markets.**
2. **A detailed map of target customers and their purchase-to-payment journey**
3. **A digital infrastructure capable of integrating new internal and external product and delivery channel capabilities.**
4. **A strategy for leveraging third parties to augment services and support rapid speed-to-market.**

Payments providers can no longer afford to segregate portfolios into product types and then ask customers to fit themselves into these silos. Consumers and small businesses want relevancy and the ability to pick and choose their service providers. Once a consumer decides to make a purchase, the point of payment is an inflection point in the journey. If financial institutions don't lean into that decision with a relevant branded payment type, merchants are increasingly happy to offer their own preferred payment. This is a main reason why open banking and A2A transfers are such important dynamics. In a recent EY survey of U.S. consumers, 64 percent placed the highest value on the ability of a bank to integrate third-party tech partnerships into a seamless experience.[16] Banks can translate this demand into higher customer lifecycle value through digital transformation.

16 https://www.ey.com/en_us/nextwave-financial-services/how-financial-institutions-can-win-the-battle-for-trust

About ICBA Payments

ICBA Payments, a subsidiary of the Independent Community Bankers of America® (ICBA), has been managing payments solutions for the nation's community banks since 1985.

We help power the potential of ICBA members through payments-related innovation, education, and advocacy to help community banks navigate the payments ecosystem and select suitable offerings at favorable pricing—helping community banks compete and thrive.

As a trusted strategic partner, ICBA Payments also provides consultative services, industry representation and ongoing vendor support to help community banks retain their best customers, earn profitable returns, and be respected as full-fledged participants in the evolving payments landscape. The company also provides exclusive services to issuers including its Fraud Loss Protection Plan, marketing support, and product education. ICBA Payments is here to support your banks' digital payments transformation.

Contact us for more information regarding strategy and roadmap development tools.

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