The Internet Will Shake Banking's Medieval Foundations

By Claus Nehmzow

Claus Nehmzow is a Principal in the Information Technology Group in London at Booz Allen & Hamilton, the international management and technology consulting firm. For further information on Booz Allen, please e-mail Claus Nehmzow at Nehmzow_Claus@bah.com.

One of the most astonishing trends in recent technological history has been the speed with which the Internet has moved from being the sole domain of the computer nerd and the academic to a mainstream channel of communication.

But while the technology and its potential to revolutionise age old patterns of conducting business are now much more generally recognised, there is still widespread ignorance within the business community as to just how rapid that change will be.

None more so than within the banking industry where the technology offers the potential to bank at a fraction of the high fixed costs inherent to the existing business - a supply side revolution that will shake the relationship between the banks and their customers to its medieval foundations.

In 1996 the financial services group within Booz Allen conducted two surveys of Internet banking - one in the USA and one in Europe.

We conducted these surveys because our industry experience indicated that banks were increasingly viewing the Internet as a key alternative delivery channel. And because there was insufficient information about current usage, growth projections and the attendant strategic implications for the industry.

The surveys were conducted with North-American and European banks that currently have bank sponsored Internet sites, and included savings institutions and credit unions. The response rate was 31 per cent in Europe and included responses from 29 per cent of the continent's largest 200 banks.

The Survey Findings

What we found is that Internet banking will almost certainly become a major fully-fledged distribution channel of banking services and products in Europe within the next three years. While current functionality is limited, 80 per cent of European survey respondents said that they planned to upgrade their web sites to facilitate most traditional banking transactions within that period.

Moreover, mirroring US growth in banking Web sites which quadrupled last year, our survey in Europe found annualised growth running at 90 per cent, with a projection for more than 2000 European banking institutions being on line by the end of the millennium. Ultimately, we believe, all banks will have a web presence as the cost advantages are so huge that there is no reason not to try it out.

The cost of the average payment transaction on the Internet is just 13 cents or less. This compares with 26 cents for a personal computer banking service using the bank's own software, 54 cents for a telephone banking service and one dollar eight cents for a bank branch.

For the traditional players in the banking sector the technology offers the opportunity to add a low cost distribution channel for their myriad services. But it also poses a much more serious threat to their market share, as it neutralises so many of their competitive advantages of having a traditional branch network.

Furthermore, costs of integrating multiple channels are higher. For a green field player starting an Internet bank from scratch, buying the software off the shelf, costs about one million dollars. But for the European dinosaur bank, integrating it with your existing systems will be much more expensive. Adding another channel - even a very low cost one - without reducing traditional channel costs, just adds to the overhead. The key challenge lies in re-engineering and optimising the traditional branch network.

It is inevitable, therefore that the banks' relationship with its customers is going to have to be redefined, if their most valued clients are not to be cherry picked by the new entrants. We estimate that by the turn of the century more than 15 per cent of US households will have Internet banking. And because these pioneers will largely be drawn from the upper-income (and more profitable) groups, they will embody 30 per cent of profits in the retail banking sector. In this brave new world of banking the customer will truly be king.

In Europe, computer ownership may not yet be as highly developed as in the States. But the costs benefits are so persuasive, that the trend is sure to similarly develop with minimal time lag, especially once concerns about security have been overcome.

For the public no two words are currently less synonymous than the Internet and security. Consumers, business people and financial institutions alike are unnerved by the vision, given substance by the popular press, of the nerd demon hacking in to steal credit card numbers and drain accounts.

The reality, of course, is different. Internet banking, will in fact make tomorrow's financial system more secure. Electronic check, in which the consumer uses a unique password protected digital signature, which is also digitally signed by the customer's bank, will be a much more secure system than the paper based equivalent.

With credit cards, the Secure Electronic Transaction (SET) standard, recently adopted by Master Card and Visa, will perform a similar function to electronic check, in securing payments with the merchant never seeing a credit card number, only a message that the card has been issued by Bank A. The Internet will, in fact, reduce hugely the capacity for fraud. And even if the system gets cracked and an account is broken into, the only way to get money out is to transfer it into another bank producing an obvious paper trail.

Effective security technologies are already here - the challenge lies in adopting the best set of operational processes and technologies to form a cost effective protection scheme. But it should be done in an integrated way, not on a single component basis.

To conclude, Internet banking is going to develop much faster than most people imagine. In cost terms alone it is an irresistible force. The financial muscle of the pioneers will, without doubt, transform the traditional relationship between a banker and his customer where the latter is king. And with the revolution, a new financial system will evolve that in many ways will be far more secure than the one we have today.