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How digital banks can succeed in the GCC

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The GCC appears to be ripe for digital banking. There is a large, young, digitally native population that is often dissatisfied with conventional banks and that has few options for a pure digital banking experience. There is also a significant underbanked population that struggles to access conventional banking services, because the people either are self-employed or have low incomes.

To capitalize on this opportunity, two digital banks recently secured licenses from the Saudi Central Bank, while in the UAE two entities have obtained the necessary licenses to operate digital banks. However, the promise of digital banking comes with peril. Experience elsewhere suggests the path to profitability for digital banks has been challenging and that reality has not kept up with expectations.

To succeed, digital banks should internalize three lessons and respond appropriately:

1. The first lesson is that customer acquisition is a slog. Dissatisfied though many people claim to be with traditional banks, they are remarkably loyal. Moreover, in the GCC the corporate relationship is very important, with many people using their employer's bank. That makes changing banks unappealing.

2. The second lesson is that digital banks often have to spend a lot on attracting customers. They use minimal fees (e.g., freemium plans or new customer incentives), which takes advantage of their lower cost structures compared to traditional banks. Although this has been successful in developed markets, it might not work in the GCC. Moreover, incumbent banks possess underwriting and risk management capabilities that digital banks often discover are hard and costly to duplicate.

3. The third lesson is that despite the cost to acquire customers, many of these new customers are inactive. Data from the U.K. show that very few customers switch their primary accounts from incumbent banks to digital banks despite how easy it is now. Recent surveys show that less than 10 percent of U.K. customers use digital banks as their primary financial institution. That is a problem for digital banks because primary bank accounts are substantially more profitable than non-primary ones. Indeed, non-primary accounts often lose money. In the banking business, you always want to be the customer's first account, the first card out of the wallet. There is no prize for coming second.

Building on these lessons, we believe that digital banks need to adopt tailored strategies to succeed. In the case of the GCC, this means three complementary approaches:

First, digital banks can pick a customer segment and solve its specific pain points — and not seek to compete immediately across the entire retail market. A digital bank should solve distinct, stubborn problems to become a customer's primary bank. For example, gig economy workers often do not have access to the same banking services as employees — such as lending. Digital banks could also choose to target micro and small companies that the financial system consistently overlooks. These companies often need value-added services such as cash-flow management and preparation of tax filings. Or digital banks could pursue the employees of small and medium-sized enterprises. In this way, digital banks can make more focused investment.

Second, rather than simply spending money to acquire new customers (usually at a loss) digital banks should explore new pricing models to demonstrate a path to profitability through incentivizing usage. Instead of making money on lending products, they could charge a subscription fee, or offer a premium account that provides access to such value-added services as metal cards, free travel insurance, free ATM withdrawals, and partner offers. For example, Monzo in the U.K. recently launched a premium account, complete with a metal payment card, for £15 US$21 per month. N26 in Germany and Revolut in the U.K. have announced that they will introduce low- and mid-tier subscription plans. These methods lower the risk of attracting loss-making customers, people who sign up for the incentive but then have dormant accounts.

Third, digital banks need to de-risk by exploring business models that can help them compete more effectively against financial technology firms (fintechs) and GCC banks. Many leading GCC retail banks have cost-to-income ratios of 30 percent to 35 percent compared to 45 percent or more in most developed markets. Incumbent GCC banks hold low-cost deposits due to religious concerns about interest earning. In response, digital banks can partner with an appropriate third party to reduce the up-front investment and lower the break-even mark. Having the right business model can help a digital bank focus its capital expenditures on select features and domains, as opposed to building an entire bank from scratch.

A digital bank could, for example, focus on offering "banking-as-a-service" to fintechs or traditional banks struggling to develop digital capabilities. Or it could offer a banking "super app" to third-party, non-financial services companies and earn commissions from generating leads. Another option is to develop embedded solutions for third-party platforms, such as online marketplaces and games, so that they integrate a financial service into a non-financial product, service, or technology.

Digital banking has promise in the GCC. Aspirant banks will need to tailor their approaches to the market carefully, combining the patience necessary to build a loyal customer base with the need to act as swiftly as possible.

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