

You've applied for a Virtual Bank license, what's next?

Hong Kong is preparing for the arrival of virtual banks (VB) — pure digital players that offer banking services solely through digital channels without bricks-and-mortar branches.

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BELOW ARE THE FOUR KEY DRIVERS behind Hong Kong's Virtual Banking initiative. The initial batch is expected to enter the market by 2019, after the issuance of the first VB licenses. Despite the obvious cost benefit for VB, compared to traditional banks that operate expensive branch networks, there are significant challenges to overcome in order to establish a successful business.

In this article, we highlight three main considerations for setting up a VB and our overall hypothesis of survival and profitability.

What is your differentiating proposition?

With HKMA's recent announcement of receiving 29 applications for VB, competition is expected to be intense. It is crucial for new entrants to find their unique foothold and stand out in a highly mature market dominated by traditional banking giants and limited adoption rates of new banking technologies by local customers.

Focus on Customer Needs

Customer centricity throughout the customer lifecycle is the top priority to consider when designing a digital banking offering. Basic banking services are about fulfilling three main needs of the customer:

- How do I pay or get paid?
- How can I borrow?
- How do I grow or protect my savings?

Green field VBs have the unique opportunity to start fresh and do things truly differently for their customers.

Therefore, a good starting point is to identify existing customer pain points in the user journey and propose innovative ways to create a delightful digital experience.

Capitalize on strong partnerships

FinTechs have traditionally excelled in one particular area (e.g. p2p lending, remittance and FX conversion).

Instead of competing head-on with other FinTechs, VBs can choose a more collaborative model in which the bank acts as a marketplace where all kinds of FinTech and consumer applications are offered. Similar to a supermarket, its shelves are filled with own-brand as well as third-party branded products.

In a platform model, a VB will be less focused on developing a completely new and disruptive offering, but more on the successful bundling of services and

their delivery to the customers in a way that keeps them coming back.

The importance of network effects and the power of the immediate and indirect feedback loop have been proven by many retail loyalty and affiliate programs pioneered by credit card companies and others. VBs that only offer basic banking products will likely fail to differentiate themselves. We believe that VBs must bundle value-adding services with their basic products and go beyond the conventional boundaries of financial services to stand out.

Avoid a Pure Discount Model

VBs can leverage their lower operating costs to provide lower fees, higher deposit rates or other price incentives to attract customers. However, without a clear differentiating proposition, a pure low-cost play will not be sustainable.

If the service offering is insufficiently differentiated in the eyes of the customers, competition will continuously undercut each other by offering a slightly better deal in order to steal each other's customers, triggering a race to the bottom.

How to achieve profitability and business sustainability?

One of the HKMA's key requirements is for VBs to have a credible and viable business plan. Growth objectives should be clearly defined. The use of predatory business tactics is discouraged for the sake of stability in the banking sector. VBs therefore have to identify their main profit engines in setting up the business cases.

Road to Profit Realization

When designing the product portfolio, VBs can take a three-stage approach to formulate a profitable product offering. To start with, in order to fulfill HKMA's VB requirements, the minimum service offering has to be incorporated. VBs need to engage customers by providing basic account services, such as CASA. This builds the first point of contact in which the account serves as the foundation for any products that are going to be offered in the future.

At this stage, customer acquisition happens at the expense of profitability as account services generate little to no income. VBs must be patient as this is an inevitable stage that new entrants face in any market.

After accumulating a decent customer base, VBs should experiment with different product propositions on a small scale to look for the optimal offering through market responsiveness tests. Extrapolation of full-scale performance can then be done by analyzing

data from the tests. Loss may still be incurred at this stage, but the potential profit of finding the optimal offering outweighs the loss.

At the final stage, VBs have successfully identified their incomedrivers. Full effort on marketing and sales activities can be launched at this stage. However, VBs need to be aware that the market landscape is constantly being reshaped by factors such as customer preferences, competitors and regulation. Close performance monitoring is required to adapt proactively to changes.

Wealth Management Services - A Lucrative Market

Being the second largest offshore wealth centre in the world, Hong Kong offers the full range services for investors to choose from. By December 2017, the Asset & Wealth Management (WM) Business in Hong Kong has reached the scale of HKD 24 trillion¹, with

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retail investors contributing over 60% of the figure. Retail investors hold HKD 0.43 million of liquid assets on average and are allocating 45% of it in financial products². The high profit margin associated with WM services makes the opportunity in Hong Kong particularly attractive for VBs.

Among different trading and advisory channels, online platforms are gaining popularity among the digitally savvy middle class investors. The Securities and Futures Commission (SFC) has issued the



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Guidelines on Online Distribution and Advisory Platforms (effective April 2019) to facilitate the growth of such platforms. Investment advice will be made available to customers who until now did not qualify for WM and Private Banking services.

How do I create an agile, secure and scalable platform?

The banking industry in Hong Kong is going through a remarkable revolution driven by technological advancement and regulatory changes. What has been the realm of banks for decades in the past, is all of a sudden challenged by new market entrants with completely different business models. Such an environment plays to another advantage of VBs over incumbents, the need for agile and quickly scalable platforms.

Modular Structure

Platforms which are built in a modular structure, enhance the agility of VBs. Different functions can be packaged into clearly distinguishable modules that allows plug-and-play. For example, a VB that only offers CASA can simply plug-in a wealth management module on top of their core platform and start offering such service if the bank wishes to follow a trend in the market. This greatly reduces the complexity of system changes as every module can easily be integrated, thus minimizing implementation time and cost.

Open Architecture - Open Banking

Hong Kong has made its first step towards an open banking model, in which banking data (product,



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client...) can be shared and accessed by third-party providers.

This offers tremendous opportunities for VBs. Other than for incumbent banks where the establishment of an open API platform can be a complex undertaking, VBs have the advantageous opportunity to design their platforms from beginning for these new possibilities. This should further enhance their ability to come up with innovative solutions for today's financial needs of customers.

Technology and Data Security

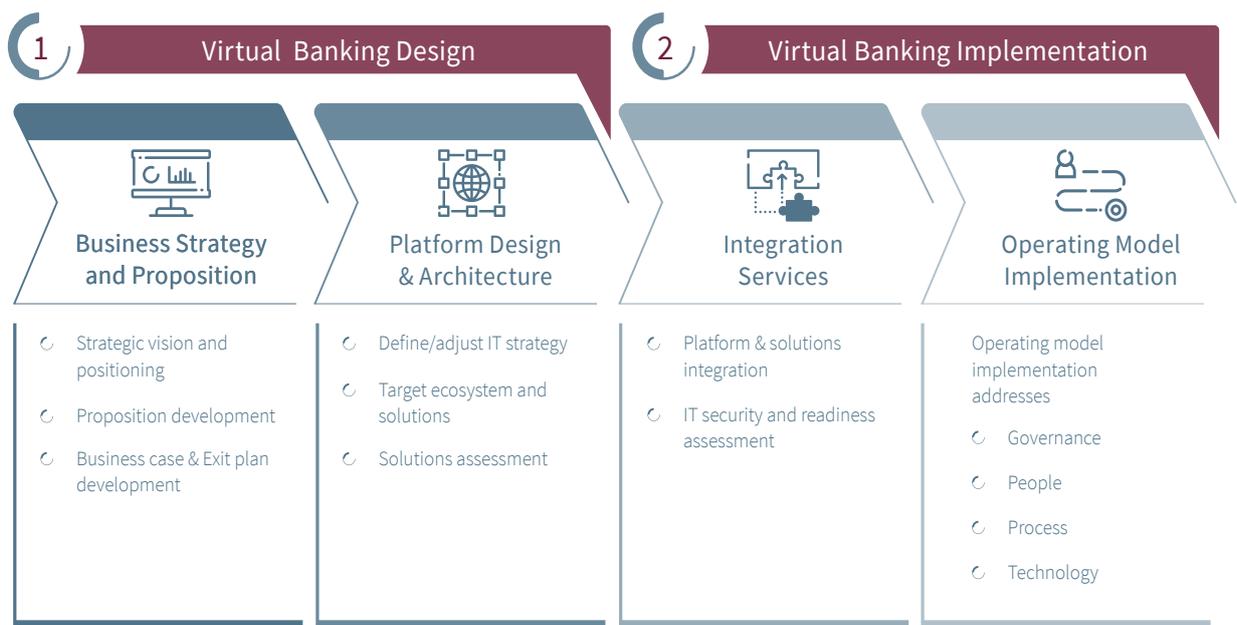
VBs are by their very nature highly exposed to technology risk and cyber crime as pure digital channel offerings create large attack surfaces. It is crucial for VBs to implement an IT governance framework to align their platform architecture with risk mitigating strategies. Besides, channels should be hardened properly against intrusion and tampering. As required by HKMA, VB applicants are expected to engage an independent expert for technology assessment on different aspects, such as hardware, security policy and protection of data.

How Synpulse can help you?

Synpulse provides end-to-end support for VB projects. Depending on the stage of such a venture, we facilitate business strategy and business case definitions, assist in the solution assessment and configuration and eventually provide full scale implementation of your operating model.

Synpulse has engaged with pure digital banking players and FinTechs in Hong Kong and globally, to help them realize their competitive advantage.

Our expertise in the digital banking area combined with our bespoke tool sets, such as Virtual BANKINABOX®, lead to cost efficient and short time-to-market solutions.



3 Phases of virtual banking design and implementation