Making the right moves
Global banking outlook 2012-13

ERNST & YOUNG
Quality In Everything We Do
Markets may have staged a strong recovery in the first few weeks of 2012 but the sustainability of that run remains in doubt, and within much of the banking industry, the mood remains much less positive. Conventional wisdom is that it may stay that way for a while longer ... and for many banks it will. Macroeconomic pressures and regulatory changes are squeezing profitability from both sides and point to a challenging environment for the industry as a whole.

On the regulatory front, implementation has already begun in some areas and we should see more clarity from regulators during the course of 2012. However, many aspects of that agenda are still evolving, particularly at a national level, and banks find themselves trying to crack a complex code to determine the best path for their future without all the clues at their disposal. As those clues reveal themselves, the extent of the impact on business and operating models will become much clearer.

Whether viewed through an economic, regulatory or business lens, it is far from a level playing field and for some, the mood is more positive. Institutions able to invest will find select opportunities to strengthen their competitive position and grow. Others will become smaller and less complex, focusing on core strengths and identifying innovative ways to serve their clients. Technology is likely to be both an enabler and a differentiator across every part of the business.

With this, our first global banking outlook, we've focused on 2012 and 2013. This time frame will be crucial as banks not only react to short-term events but also try to move ahead of them to a future with sustainable revenues and costs.

We present a global view, drawing on macroeconomic and industry analysis, as well as a drill-down into some of the major developed and rapid-growth markets.

We hope you find this outlook useful as you address the issues, challenges and opportunities ahead, and we very much look forward to any feedback you may have.

Steven Lewis
Lead Analyst
Global Banking & Capital Markets Center

March 2012
Contents

01 Executive summary

04 Banking in context – the global economic outlook

06 Regulation casts a shadow across all markets

10 The outlook for banking – reshaping the industry during economic and regulatory uncertainty

17 Outlook for selected markets

18 Americas
  19 USA
  21 Canada
  22 Brazil

23 Europe
  24 UK
  25 Eurozone
  28 Switzerland

29 Asia Pacific
  30 Japan
  31 Australia
  32 China
  33 India
  34 Indonesia
Institutions face increased competition from each other and from non-traditional new entrants — those banks unable to adapt in time will be at risk.
Executive summary

2011 didn’t turn out quite as planned for the global economy or for the banking industry. The anticipated growth didn’t materialize, consumer and business activity mostly failed to recover, legislators and regulators were unable to deliver much-needed clarity and consistency and public perception of banks remained resolutely negative in many markets.

Events in Europe and the US combined to send shock waves across both developed and rapid-growth economies. Global equity markets ended the year down over 12%, wiping almost US$6.3t off their value, and both companies and individuals generally ended the year less confident and more uncertain than they began it. There have been some positive signals in both developed and rapid-growth economies in early 2012 but, in Europe especially, the malaise is likely to last well into 2012. GDP growth will remain either negative or weak and the emphasis will remain on deleveraging rather than spending and investing.

This slow-motion recovery has been particularly challenging for the banks. With the cost of doing business continuing to increase dramatically and return on equity (ROE) expectations much lower than in the past, many banks had already initiated enterprise-wide and multi-dimensional change programs to develop and implement new target operating models, and restore investor confidence.

Unfortunately, they had anticipated a much more benign economic environment in which to adapt to the paradigm shift in the banking landscape. Now banks face a near-perfect storm of challenges and conflicting demands in a volatile and uncertain environment, locally and globally.

For all these reasons, banks may be tempted to watch and wait, but that may be a mistake as the rate and extent of slowdown vary significantly across industry sectors and geographies. A recession may be unavoidable in Europe but elsewhere, growth has been sustained, albeit at a lower level. This trend should continue, barring a major slowdown in China or a geopolitical shock, such as a significant rise in tensions in North Africa, the Middle East or North Korea. Governments and central banks across the world continue to take unprecedented measures to stimulate growth.

In many of the rapid-growth economies, companies are forging ahead and consumer demand has not fallen to the extent that it has in some developed markets. Customers are looking for advice from banks and solutions to address their own new challenges.

Accordingly, as institutions face increased competition from each other and from non-traditional new entrants – other financial services providers, “shadow” banks, technology companies or major retailers – those banks unable to adapt in time and develop and execute a credible strategy will be at risk.

As banks navigate their way through the next 12-24 months, we see a number of key issues and themes that need to be considered if banks are to grasp the opportunities that may arise, as well as overcome the significant challenges that definitely lie ahead.
Press ahead or risk falling behind
Most banks are struggling to manage costs, grow and also deliver on multiple change programs. Significant restructuring programs have already been announced by many of the world’s largest banks to cut costs and improve profitability, but with mixed success.

Faced with an uncertain future and mounting pressure to improve sub-par ROE, many institutions are considering cuts or delays to their change agenda. While this may be unavoidable for some, the danger is that banks will miss the limited window they have to implement their future blueprint and be overtaken by existing competitors or new market entrants.

Maintaining flexibility to respond to unknowns will be important but, particularly for those banks operating in rapid-growth markets, change must be an immediate imperative to avoid losing clients to established global institutions or emerging regional banks.

Opportunities as competitors disappear
Regulatory reform will be a challenge for all, and to some degree it will be a leveler, but it will also highlight the strengths of some institutions and the weaknesses of others. Over the course of the next 12–24 months, we are likely to see a widening gap between the leaders and the rest of the pack, geographically and across products and services, as banks refocus and, in many cases, shrink.

“Deglobalization” is being actively encouraged by some regulators, and many European institutions, in particular, will be withdrawing from markets and business lines as they deleverage. With relatively few buyers in the market for many assets, banks that can respond at the right time to acquisition targets will have an opportunity to strengthen their existing business at a highly competitive price.

Opportunities will exist in both developed and rapid-growth markets for banks with appropriate business models, particularly as others retreat from global coverage models. Businesses that require less capital, such as wealth management and transaction banking, will continue to be attractive, but competition will become more intense. However, with the landscape shifting so fundamentally, current competitors may not be future competitors, and the challenge will be to second-guess what others are planning.

Competition or partnership
Non-traditional providers of banking services are emerging in both corporate and retail banking to disintermediate the banks. Some organizations, such as technology companies and retailers, are looking to leverage their brand, their customer relationships and “bank-in-a-box” technology. Others, such as hedge funds and private equity funds, see the banks’ capital and liquidity constraints as an opportunity.

However, the expertise and infrastructure that banks have built up is not easy or cheap to replicate. Instead of viewing this as a wholly competitive scenario, partnership may deliver benefits to both. As resource-constrained banks struggle to invest on their own and raise funds to lend, they may be able to leverage the best of old and new to emerge as market innovators. They may also be able to partner with other banks to restore or improve market and product coverage lost through deleveraging.

Keeping close to the right customers
Banks are not always seen as market leaders in customer service and, as is probably true for any commercial organization, they find it difficult to decline a new business opportunity. When these factors are combined with the overwhelming resource constraints and increasing capital requirements faced by many banks, there is a danger that banks do not focus finite resources on the right customers.

As new challengers are targeting the changing expectations of individual and corporate customers, developing a “whole-customer” view of requirements and profitability is an essential, but often lacking, capability. Banks that can deliver this analysis, particularly when business models are still being redefined, will be able to ensure their future strategy is aligned with key customers and focused on increasing share of wallet with those clients.

Technology – enabler and differentiator
Whether it’s helping to better understand customer profitability, deliver products in innovative ways or manage the spiraling data requirements as a result of new regulation, technology will emerge as both a key enabler and differentiator over the next couple of years.

All spending is under heavy scrutiny at the moment but, as the role of technology evolves, banks will need to think about technology expenditure in a different way. Instead of being a cost to manage down, it will be seen more as an investment to support growth and new business development.

Where to focus investment (e.g., core back office vs customer delivery) should become less of an issue if silos are stripped out and system connectivity runs throughout the organization. The challenge, particularly in service delivery areas such as mobile banking, will be to replace old with new and not incur the additive costs of old and new. In these areas, a highly focused customer strategy will be crucial.
Risk — balancing models and judgment
The profile of the risk function has been elevated significantly as regulators require banks to implement comprehensive reforms to improve the definition and management of risks for the organization. Progress has been made but the challenge now is to embed risk appetites into the organization, institutionalize a strong risk management culture and operationalize all of that into daily activities.

As the broad concept of risk management continues to evolve over the next couple of years, banks will need to focus on maintaining the right balance between systems, processes and models and experienced judgment. Having implemented policies and procedures to manage day-to-day risks, the issue will be to retain enough agility in the organization’s approach to risk to enable identification and mitigation of emerging risks.

We are likely to see a widening gap between the leaders and the rest of the pack, geographically and across products and services, as banks refocus and, in many cases, shrink.

As the banking landscape undergoes some fundamental changes over the course of the next couple of years, there will be a mix of art and science as institutions identify the right target operating model and figure out how to implement it in the current economic and regulatory environment.

Some will continue to expand; for others, withdrawing to a redefined set of core products and markets will be the answer. As our drill-down into a number of selected markets shows, opportunities do exist in both developed and rapid-growth economies.

However, the challenge that all banks face is to determine how to harness existing capabilities and invest in new ones in a way that carves out a sustainable future position. As performance continues to suffer in the short term, crafting a credible story that convinces investors, customers, staff and other stakeholders will be crucial.
As confidence and certainty drained away from investors, businesses and consumers in developed and rapid-growth markets during 2011, growth forecasts for 2012 and 2013 were frequently revised downward (see Table 1). For those developed economies with unsustainable levels of public debt, particularly in Europe, the next couple of years will be especially challenging as the necessity of paying down debt further constrains growth in the short term. Across many of the rapid-growth markets, the focus of attention has switched from fighting inflation to protecting growth. Monetary policy has been relaxed, and interest rates will continue on a downward trend. Governments and central banks are also becoming more aggressive and creative in their efforts to stimulate the economy and support banks. Beyond lowering rates, the authorities are using an expanding group of levers to move liquidity back into the economy, including the extension of the central bank’s balance sheet to buy debt and the lowering of banks’ reserve requirements. However, in the short term, much of this additional liquidity has ended up back on deposit with the central banks (for example, overnight deposits with the European Central Bank [ECB] increased nearly fourfold during 2011).

By the end of 2013, we will also have seen presidential/government elections in over half of the G20 economies (as well as a new Chinese president announced in March 2013), with the potential for further political and economic upheaval and politicization of banking reform, irrespective of the results.

In the developed and rapid-growth markets, the challenges and opportunities for the banks will be quite different:  
- Even with agreement on a second bailout for Greece, uncertainty over growth and employment will persist in Europe, in the short term at least. Businesses and consumers there are likely to further reduce their current debt burden and delay nonessential investments.
- The US and Canadian markets have seen some increased loan activity but, in the US particularly, demand for banking products at an aggregate level will be slow to rise as customers remain wary.
- As demand does return in developed markets, it will tend toward simpler and cheaper products.
- Customers who do need to act in the short term may be higher risk categories looking to refinance or consolidate debt. In Europe certainly, and possibly elsewhere, loan defaults may increase and banks will need to restore provisions only recently released.
- Low interest rates will eventually stimulate demand but continue to depress margins, as creditworthy groups in particular shop around to take advantage of the best deals.
- Some of the highest-rated multinationals will continue to eschew loans and access capital markets when windows open – particularly if spreads continue to be lower for them than for the banks – but this will be sporadic.
- For capital markets, trading and M&A, volatility will promote lower activity levels and less risk-taking until there is more
As confidence and certainty drained away from investors, businesses and consumers in 2011, forecasts for future growth were frequently revised downwards.

certainty. However, the significant levels of asset sales by banks themselves will create opportunities for advisory teams, as well as for those banks in a position to engage in acquisitions.

In the rapid-growth markets, there are selective opportunities:

• Rising income levels and a growing middle class with more disposable income will create increased demand for banking products to support both individual and corporate customers.

• International companies will be focusing more attention and investment capital on these markets and more local and regional companies will begin to emerge as global players.

• Global banks with developed franchises will continue to benefit, particularly in corporate and investment banking and wealth management.

• The repatriation of assets by struggling European banks, historically a significant source of credit and trade finance, may affect short-term growth prospects in some rapid-growth markets. However, this will also create significant opportunities for other banks to develop and strengthen relationships with corporate clients.

• Over the medium term, local market reforms should also benefit international companies and financial institutions; however, this trend may be a slow burner, particularly during the next couple of years, as local politicians favor protectionism over economic liberalism.

• Local banks will pose an increasing threat to international institutions as they continue to leverage their natural home advantage and develop the expertise to expand beyond their home jurisdictions. Increasing trade and capital flows between rapid-growth markets may favor banks from those markets that are able to expand to support their domestic clients overseas.

• Rapid-growth markets do not represent the “pot of gold” for which some banks might be hoping, and it will be particularly difficult for new entrants in some markets. For banks without an existing credible presence, it may not be feasible to plant a flag in economies grabbing the headlines today.

• Identifying the “next generation” of rapid-growth markets and focusing resources on gaining a market-leading position there may offer better prospects.

<table>
<thead>
<tr>
<th>Country</th>
<th>2010</th>
<th>2011*</th>
<th>forecast for 2012</th>
<th>forecast for 2013</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td></td>
<td></td>
<td>At Feb 2011</td>
<td>At Feb 2012</td>
</tr>
<tr>
<td>Argentina</td>
<td>9.2</td>
<td>8.3</td>
<td>4.3</td>
<td>3.9</td>
</tr>
<tr>
<td>Australia</td>
<td>2.6</td>
<td>1.9</td>
<td>4.2</td>
<td>3.1</td>
</tr>
<tr>
<td>Brazil</td>
<td>7.5</td>
<td>2.8</td>
<td>5.1</td>
<td>3.1</td>
</tr>
<tr>
<td>Canada</td>
<td>3.2</td>
<td>2.3</td>
<td>3.0</td>
<td>2.0</td>
</tr>
<tr>
<td>China</td>
<td>10.4</td>
<td>9.2</td>
<td>9.0</td>
<td>8.4</td>
</tr>
<tr>
<td>EU</td>
<td>1.9</td>
<td>1.6</td>
<td>2.1</td>
<td>-0.2</td>
</tr>
<tr>
<td>France</td>
<td>1.4</td>
<td>1.6</td>
<td>2.0</td>
<td>-0.2</td>
</tr>
<tr>
<td>Germany</td>
<td>3.6</td>
<td>3.0</td>
<td>1.8</td>
<td>0.6</td>
</tr>
<tr>
<td>India</td>
<td>8.7</td>
<td>7.1</td>
<td>9.0</td>
<td>6.5</td>
</tr>
<tr>
<td>Indonesia</td>
<td>6.2</td>
<td>6.5</td>
<td>6.5</td>
<td>6.2</td>
</tr>
<tr>
<td>Italy</td>
<td>1.4</td>
<td>0.4</td>
<td>1.1</td>
<td>-1.6</td>
</tr>
<tr>
<td>Japan</td>
<td>4.5</td>
<td>-1.0</td>
<td>2.0</td>
<td>1.3</td>
</tr>
<tr>
<td>Mexico</td>
<td>5.4</td>
<td>3.9</td>
<td>5.2</td>
<td>3.8</td>
</tr>
<tr>
<td>Russia</td>
<td>4.0</td>
<td>4.3</td>
<td>5.2</td>
<td>3.7</td>
</tr>
<tr>
<td>Saudi Arabia</td>
<td>4.6</td>
<td>6.8</td>
<td>4.5</td>
<td>4.5</td>
</tr>
<tr>
<td>South Africa</td>
<td>2.9</td>
<td>3.0</td>
<td>4.1</td>
<td>2.4</td>
</tr>
<tr>
<td>Korea</td>
<td>6.2</td>
<td>3.6</td>
<td>4.8</td>
<td>2.8</td>
</tr>
<tr>
<td>Turkey</td>
<td>9.0</td>
<td>8.3</td>
<td>6.3</td>
<td>2.2</td>
</tr>
<tr>
<td>UK</td>
<td>2.1</td>
<td>0.9</td>
<td>2.6</td>
<td>0.3</td>
</tr>
<tr>
<td>USA</td>
<td>3.0</td>
<td>1.7</td>
<td>3.5</td>
<td>2.3</td>
</tr>
<tr>
<td>Eurozone</td>
<td>1.8</td>
<td>1.6</td>
<td>1.7</td>
<td>-0.4</td>
</tr>
</tbody>
</table>

* Latest available figures for full year.

Source: Oxford Economics
Regulation casts a shadow across all markets

Irrespective of which markets a bank may be targeting, the regulatory landscape has changed since the global financial crisis and will change further during the next few years. The core pillars of the framework for the banking industry have been known for some time, yet combining the scope and complexity of the global regulatory reform agenda with national priorities has made the process highly political. Banks face ongoing uncertainty as national regulators convert global principles and standards into local rules and regulations.

As discussions at a recent meeting of the Ernst & Young/Tapistry Banking Governance Leadership Network highlighted, there is also growing concern that some of the rules may not deliver the intended benefits. The politically charged environment notwithstanding, the senior non-executive directors taking part in the September 2011 meeting felt quite strongly that banks needed to engage in the debate and use their expertise to ensure strong but effective regulation for the industry.

For the banks, and particularly for those that operate in multiple jurisdictions, it is not just a question of complying with a set of new rules. The whole approach to regulation and supervision is changing, bringing with it some significant challenges that banks must address in the coming months.

Banks are global, but regulators are national:

- The different approaches by national regulators to applying global standards will continue to be a particular challenge for the banks, which are looking for consistent interpretation. Some jurisdictions are also going beyond the global standards.

- Initiatives such as the additional capital “finish” in Switzerland, the Volcker Rule proposals in the US and the proposed ring-fencing of retail operations in the UK will all place an additional and ongoing burden on already scarce resources. They also raise the potential for conflicts between home and host regulators as hosts consider the impact of these proposals on the stability and security of their markets.

- As with the Australian adoption of Basel III capital requirements, time frames may also vary, so it remains unclear whether rules will be different and, if they are, what that might mean for the structure and location of particular businesses. Major arbitrage opportunities between established financial centers are unlikely, but continued uncertainty is not helpful.

- Further fragmentation of markets is more likely as politics come into play and governments and regulators want to demonstrate they’re protecting local taxpayers and restricting riskier activities. While this protects national economies, it may be counter-productive globally and damaging to the economic recovery as the flow of capital and liquidity, trapped in subsidiaries, is constrained.
It is not just a question of complying with new rules. The whole approach to regulation and supervision is changing, and national implementation of global standards can vary significantly.
The trend of conservatism and caution will continue:

- The challenge for the regulators will be to make these enhanced powers effective without being overly constraining. National authorities are pursuing different forms of engagement with banks – some are more exacting and prescriptive than others.
- Notwithstanding government and central banks' measures to boost economic recovery, there remains a clear drive toward increasingly intrusive supervision. The extent will vary, but boards and executive management can expect to have strategies and plans questioned far more than in the past, and planning time frames will need to adjust as the impact of this new approach becomes clear.
- Several jurisdictions have had product bans and restrictions in place for some time, but more countries are now looking to control leverage and complexity in the system through a more comprehensive approach.

A new era of regulation

Regulatory reform has the potential to deepen the divide between stronger and weaker banks and the cumulative impact of reforms will force the industry, and its investors, to adapt to radically different ROE expectations. Constricting capital and liquidity availability, new requirements that discourage many investment banking and trading strategies and a push toward more stable funding models will all lead to wholesale revisions to banking business models.

Basel 2.5, the trading risk component of the new capital rules, has already come into effect in many G20 countries. As other elements take effect and banks move toward full Basel III compliance, volumes and revenues will decline as the cost of doing business increases. Banks will face significant challenges to all aspects of their operating models – strategic planning, governance, risk management, controls, data and IT infrastructure and compensation structures.

Some reforms also emphasize “intent,” especially in consumer protection regulation, which is immensely challenging to manage and will result in dramatically increased reputational and legal risks for the banks.

The added complexity of FATCA

Although the global regulatory reform framework continues to be at the top of most agendas, the US Foreign Account Tax Compliance Act (FATCA) also has the scope to affect cross-border operations and the viability of certain customer groups. Regulations issued in February 2012 have addressed many outstanding issues but uncertainty remains around some of the final rules. Banks have limited time to assess the impact on costs, determine what is required and implement changes to the business before the rules begin to take effect in 2013.

The cumulative impact of reforms will force the industry, and its investors, to adapt to radically different ROE expectations.
Capital and liquidity

- While capital has been emphasized in the media, authorities have also pressed for dramatic remediation around liquidity. The much-contested Liquidity Coverage Ratio standard set by Basel III will have a significant impact on banking costs and operations, and the requirements related to dynamic analysis and granular reporting will represent some of the more significant analysis hurdles for the industry.

- The firm’s business strategy is now much more sensitive to quantitative modeling and risk appetites, as capital and liquidity have become definitive limitations. To improve strategic decision-making and to use scarce resources most effectively, the banks’ immediate focus will be on ensuring they have the capability to analyze a greater range of parameters when considering new initiatives. The impact of activities on risk-weighted assets, funding and economic capital will need to be analyzed together.

Resolution planning

- Most countries have required that all G-SIBs (global systemically important banks) and some domestic SIBs (systemically important banks) submit resolution plans to local regulators by year-end 2012, with implementation during early 2013.

- With limited prior experience of resolution plans, industry understanding of living wills and what they need to contain continues to evolve. As well as developing a plan, for some it will also involve the removal of impediments to resolution on an ex-ante basis, including restructuring legal entities and moving capital and liquidity.

- For banks with cross-border operations, the differing requirements and timetables established by national regulators will continue to be challenging. Variances in approach will also make it much harder to develop resolution plans that satisfy both home and host regulators, particularly where some form of organizational restructuring forms part of the requirement.

OTC derivatives

- Post-crisis OTC derivatives reforms aim to establish a greater degree of standardization, transparency and protections in the swaps marketplace. New reforms will also require drastic infrastructural shifts and ultimately lead to a certain amount of deleveraging of those markets.

- If the authorities remain on track in their plans, the majority of the US and the EU swaps markets will be cleared as of next year, although delays have already occurred.

- The transition will begin with the decision on which part of the transaction chain to occupy. This will determine a bank’s reporting and record-keeping requirements at a minimum, and may affect other aspects of its operations, including legal entity structure, business conduct, capital and margin, collateral management and risk management requirements.
The outlook for banking
Reshaping the industry during economic and regulatory uncertainty

At a global level, the economic and regulatory environment makes the outlook for the banking industry particularly challenging, irrespective of geographic or product focus. Business and consumer confidence has not yet been restored, and market volatility and economic uncertainty will continue to act as brakes on major investment decisions. As a result, banks may continue to underperform broader market indices (see Chart 1).

We see a number of themes and issues playing out over the next couple of years and, while there are a number of significant hurdles to overcome, opportunities do exist.

Press ahead or risk falling behind
Over the next 18-24 months (and possibly longer), banks will be faced with competing priorities and scarce resources as they try to implement major change programs to fundamentally reshape the business and redefine the target operating model.

The challenge has become that much harder as the anticipated strong economic recovery failed to materialize. While the inclination may be to stop or slow down some of these changes, the outlook in the medium to long term will be worse for those that don't (or can't) press ahead.

The cost and ROE profile of most banks will alter radically as a result of regulatory reforms. Even without the current crisis, revenues had been hit as interest margins fell and the demand for some products disappeared as a result of the last crisis. Increasing prices will not be a solution in many cases and the affordability of reform has become a real challenge.

Banks have already announced major headcount reductions, smaller bonus pools and new efficiency programs as they try to move onto a more sustainable cost base; the top 40 global banks alone had announced staff cuts totaling nearly 150,000 by 1 February 2012.

Faced with renewed economic uncertainty as well as regulatory unknowns, the temptation may be to “wait and see” for all but mandatory or maintenance initiatives until the outlook becomes clearer (and more positive).

For some banks, the only option will be to cut spending and postpone change as the revenue growth to pay for investment fails to materialize. For many, investor and market scrutiny of quarterly earnings statements will also weigh heavily on decisions. For most banks, however, delaying the inevitable until after the recovery could be a mistake, as existing and new competitors look to exploit missed opportunities.

The juggling act of balancing short-term imperatives against medium-term strategic development will be more of an art than a science. Yet pressing ahead with the business transformation agenda – while building in flexibility to ensure future business and operating models will be agile enough to respond to unknowns – could deliver significant competitive advantage as confidence improves and corporate customers dust off their growth plans.
The global banking landscape will be redefined. There will be fewer banks, and those that remain will be less complex. In some markets, this is exactly what regulators are hoping for.

Chart 1. Performance of top 40 global banks against market indices**

** Chart 1. Performance of top 40 global banks against market indices**

* Excludes Credit Mutuel, Groupe BPCE, Norinchukin Bank and Rabobank, which are not publicly traded, and Agricultural Bank of China, which was not publicly traded until July 2010.
Source: Capital IQ

** Within the report, the “top 40 banks” refers to the top 40 global banks by assets based on the 2010 financial year.

Opportunities as competitors disappear

Higher costs, scarce funding, declining demand and lower returns have made the status quo unprofitable and untenable. Without a scale advantage or a market-leading position, sustainable returns will be difficult to achieve. With ROE declining and many banks trading at a price or book ratio below par (see Charts 2 and 3), a “me too” strategy is no longer viable.

Global vs regional vs niche vs utility

Over the course of the next 18-24 months, the global banking landscape will be redefined and become less global as we see more targeted and focused institutions. There will be fewer banks, and more of those that remain will be less complex. In some markets, this is exactly what regulators are hoping for.

For some, this will be strategic de-risking and for others, it will be forced but, either way, it may not be bad news for the banks or their investors. As new target operating models are defined, organizational structures will be simplified, legal entities will be merged and activities will be consolidated in core locations. Compensation strategies will also need to be revised to reflect new, often simpler, business models and product portfolios.

What to offer

As competition in some corporate and investment banking areas decreases, in other business lines it will become more intensive. There has been considerable focus on banks expanding their coverage in low-capital and transactional products, such as cash management, custody and trade finance.

However, the perceived attractiveness of these is misleading for banks that don’t already have a compelling proposition for customers; the combined targets of banks appear to be adding up to a lot more than the size of these markets. As customers also worry about the safety and stability of their banks, institutions not considered systemically important at either a global or national level may find it harder to attract new business. The exception may be those banks that can demonstrate a market leadership position in a particular product or service.
Where to compete
Faced with the European Banking Authority’s (EBA) 9% capital requirement, many European institutions will withdraw from American, Asia Pacific and even other European markets to focus on local, core strongholds. Even within these core markets, some will stop or scale back certain activities that are capital intensive, where scale is crucial or because they need the capital released by a sale.

This retrenchment will provide an opportunity for those who already have a leadership position to become even stronger, either through selective acquisition to boost organic growth activities or simply by filling the gaps left behind.

Within rapid-growth markets, local and regional banks will also seize this opportunity to expand domestically, into neighboring markets and into other rapid-growth economies to support their corporate clients. China has overtaken the US to become Brazil’s largest trading partner, so Chinese banks will be strengthening their capability in this market.

However, acquirers of banking assets will be a scarce commodity and, from an M&A perspective, it is likely to be a buyer’s market for the foreseeable future, as the volume and value of assets for sale look set to far outstrip demand.

Although some markets have too many banks for their size, consolidation through large-scale acquisitions is unlikely in the current climate. In the retail market, local regulators will worry about further concentration risk and are likely to frown on anything other than domestic mergers between small and medium-sized banks. Cross-border activity will be more likely in the corporate and investment banking sectors though this is also likely to be at the business-unit level.

Competition or partnership?
Capital-constrained banks are facing increased competition from non-traditional sources in both corporate and consumer markets, as shadow banks, technology companies, retailers and others look to build a presence in the banking sector.

As well as responding to demand for more “vanilla” products, these organizations are also tapping into an appetite for banking services to be delivered in new and innovative ways. This new breed of competitor is nascent but growing in both lower- and higher-risk areas of business.

On the corporate lending side, hedge funds and private equity funds have identified a mid-market opportunity, targeting businesses too large for local bank loans but too small to access capital markets. There have already been examples of private equity houses taking on loan portfolios, as well as staff from banks to manage them.

Shadow banks have sometimes struggled to compete in the past but the challenges facing the banks may have given them a (temporary) advantage. However, as the regulators turn their attention to this section of financial services, some opportunities may be short-lived.

Skills transfer
In some cases, organizations are moving into the lending business more out of necessity than a desire to compete. As lending restrictions continue, particularly to small businesses, some large corporations are offering loans to the smaller companies in their

---

* 2011 calculations include those banks that had reported full-year results for financial year 2011 by 28 February 2012.

Source: Capital IQ and company reports
Asset sales will create real opportunities for some to strengthen their position, but as supply looks set to far outstrip demand, the question is “who will buy?”

Keeping close to the right customers
In the midst of the external and internal upheaval facing the banks, it is sometimes easy to forget that other sectors are growing – particularly in some of the rapid-growth markets – and businesses are looking to expand, albeit cautiously. As many banks are forced to direct more resources inward and as new traditional and non-traditional competitors emerge, customers may look elsewhere.

Selecting the customer as well as the strategy
Ernst & Young’s latest CFO survey shows that businesses are looking for institutions that can support them across existing and emerging trade routes, and offer advice as well as products. However, at an industry level, banks are not renowned for excelling at customer service or for thoroughly understanding customer requirements.

As banks develop their target business and operating models, they will also need to be much more rigorous in identifying customers that are key and determining which opportunities to target and which ones to decline. Unfortunately, many institutions struggle to analyze a “whole customer” view of profitability.

With strategies evolving over the coming months, the prognosis will be much more positive for those banks that develop this capability...
in the short term. The data can support decisions on where to
direct attention and scarce capital and investment dollars, focusing
on the clients able to deliver the best overall return and the
products they need.

More effective customer analysis will also provide banks with a much
better understanding of where there is a strong fit between the
capabilities of the bank and the requirements of current and potential
customers. Using this insight, customer segmentation and initiatives
to hold on to key current and emerging clients through an increased
share of wallet can be much more targeted.

Restoring reputation
As well as improving customer service, in many of the developed
markets, banks must also work toward restoring their reputation –
especially with retail and small business customers. The success of
consumer activism and the “Occupy” movement has been mixed
but public opinion shows some support for them.

The message that banks provide a vital service to the economy has
been lost in some markets. While customers may have a strong
relationship with their bank, at an aggregate level, their view of the
industry has been tarnished. Multiple channels do not always help,
particularly as few customers now have a single point of contact
with their bank.

Not everyone wants to visit a branch or deal with a person face-to-
face, but the decision by some banks to invest in refurbishing and
expanding their network will help to restore the public perception
of banks as part of communities. In those markets where the
economy puts more customers at risk of default, there will also be
an opportunity to rebuild trust through a more sensitive approach.

Technology – enabler and differentiator
More so than in the past, technology will emerge as both a key
enabler and a differentiator over the next couple of years. All
spending is under heavy scrutiny at the moment but, as the role
of technology evolves, banks will need to think about technology
expenditure in a different way. Instead of being a cost to manage
down, it will be seen more as an investment to support growth
and new business development. The question of where to focus
investment (core vs customer) should become less of an issue as
system connectivity runs throughout the organization.

Chart 4. Technology expenditure by banking segment (US$b)

* Includes corporate banking, capital markets,
institutional asset management, hedge funds,
investment banking and market infrastructure.

Source: Ovum Retail Banking and Financial Markets
Technology Spending Model through 2016
(published 2011-12)
As new regulatory requirements take effect, banks will become even more data intensive than they have been in the past. This will not automatically require major infrastructure projects, but the quality and extent of data expected, the connectivity between functions, the levels of risk assessment and the speed of delivery may require organization-wide change programs to implement new systems and processes.

More institutions will need to implement an enterprise-wide solution to technology to remove siloed systems and benefit from the effective collection, management and mining of data. Increased competition from existing banks, as well as new entrants to the market in some business areas, will place even greater importance on leveraging and exploiting the data banks have to better understand their customers and their own business.

Although some security concerns remain, technology will also play an increasing role in the interaction between bank and customer via multiple channels, as demand increases for better access to information and improved functionality from platforms.

Many non-traditional providers are leveraging new technology to tap into innovation and provide new services to customers. Mobile money is not new, but the increasing use of smartphones (especially ones with the Near Field Communications [NFC] functionality to enable contactless payments) is encouraging the development of mobile banking applications and the growth of mobile payment solutions (see Chart 5 for expected growth in smartphones). For business customers as well, mobile invoicing can provide a faster and more streamlined payment system.

Particularly in this environment of change, new entrants, able to create more streamlined systems and processes from scratch without the constraints of multiple legacy systems, may be more nimble and able to offer differentiated solutions more easily to customers. In rapid-growth markets such as India and Kenya, mobile technology has overcome the need for a vast branch infrastructure.

Even more than before, technology will emerge as a key enabler and a differentiator. Rather than a cost to manage down, it will be seen as an investment to support growth and new business.

Technology to comply

Technology to understand

Technology to deliver

Chart 5. Worldwide smartphone shipments by region 2010-15

Total units (millions)

<table>
<thead>
<tr>
<th>Year</th>
<th>North America</th>
<th>Latin America</th>
<th>EMEA</th>
<th>Asia/Pacific</th>
</tr>
</thead>
<tbody>
<tr>
<td>2010</td>
<td>50</td>
<td>10</td>
<td>15</td>
<td>25</td>
</tr>
<tr>
<td>2011E</td>
<td>70</td>
<td>15</td>
<td>20</td>
<td>30</td>
</tr>
<tr>
<td>2012E</td>
<td>90</td>
<td>20</td>
<td>25</td>
<td>35</td>
</tr>
<tr>
<td>2013E</td>
<td>110</td>
<td>25</td>
<td>30</td>
<td>40</td>
</tr>
<tr>
<td>2014E</td>
<td>130</td>
<td>30</td>
<td>35</td>
<td>45</td>
</tr>
<tr>
<td>2015E</td>
<td>150</td>
<td>35</td>
<td>40</td>
<td>50</td>
</tr>
</tbody>
</table>

traditional channels — rather than being cost-additive if banks need to preserve the old ones. To overcome this, we will see banks experiment further with different cost structures and incentive programs, particularly with the more technology-savvy segments of their customer base.

Risk — balancing models and judgment
It's not surprising that risk remains top-of-mind for both banks and regulators and the challenge will be to achieve a balanced approach. Over-reliance on models and systems not only has the potential to constrain innovation but may also restrict the organizational agility required to respond to emerging risks, as well as dealing with those in today's marketplace.

As Ernst & Young's survey (Making strides in financial services risk management) identified, risk functions have been under immense pressure since the 2008 crisis to improve governance processes and strengthen the frameworks, models and systems used to manage all types of risk affecting the organization — ranging from liquidity through to market, credit, operational, delivery and overall business risk.

This revolution in risk management has been embraced at the board level and the function now commands much more respect and authority throughout the organization. Risk appetites are being defined and considerable progress has been made in developing the systems infrastructure and improving modeling capabilities.

Combining systems, culture and agility?
The focus going forward, highlighted in January's report from Ernst & Young's Banking Governance Leadership Network, will be for banks to embed the newly defined risk appetites into the organization, create a strong risk management culture and embed it into daily activities. At a time when many banks are embarking on significant change programs and restructuring initiatives, this will be a real challenge.

As the broad concept of risk management continues to evolve over the next couple of years, banks will be working on combining better systems and modeling with experienced judgment. Having implemented policies and procedures to manage day-to-day risks, the challenge will be to retain enough agility in the organization's approach to risk to enable identification and mitigation of emerging risks.

Going beyond the single organization, regulators will have a role to play in ensuring that information is being shared across the industry to increase awareness and understanding of emerging risks.

Impact on selected markets
Banks do have significant hurdles to overcome but, as we’ve seen during the course of this discussion, opportunities do exist and how banks navigate the next 12-24 months will determine their longer-term prospects. The themes and issues that we’ve outlined in this section apply at a global level, but the balance between challenge and opportunity varies considerably across different markets. Over the next few pages, we take a closer look at a selection of developed and rapid-growth economies across the world.

In determining which rapid-growth markets to cover, we have tried to strike a balance between those where international banks are already well-established and those that are likely to be investment targets over the next couple of years. Hong Kong and Singapore, not covered in detail this time, will continue to be vibrant banking centers. Banks there now will continue to invest in corporate, investment banking and wealth management capabilities, particularly given the opportunities in the wider region and the uncertainty elsewhere.

However, the maturity of those markets means we are unlikely to see significant investment from banks without an existing credible presence. In the case of locally headquartered banks there and in South Korea, we are more likely to see outward investment and expansion into neighboring rapid-growth economies in pursuit of growth and in recognition of limited domestic opportunities.
Outlook for selected markets
Political uncertainty and regulatory unknowns will continue to hamper the US banks’ efforts to design their future business models.

USA

The recovery continues though not without risks

<table>
<thead>
<tr>
<th>USA</th>
<th>2009</th>
<th>2010</th>
<th>2011*</th>
<th>2012 forecast</th>
<th>2013 forecast</th>
</tr>
</thead>
<tbody>
<tr>
<td>Real GDP growth</td>
<td>-3.5</td>
<td>3.0</td>
<td>1.7</td>
<td>3.5</td>
<td>2.3</td>
</tr>
<tr>
<td>Policy interest rate</td>
<td>0.2</td>
<td>0.2</td>
<td>0.1</td>
<td>1.2</td>
<td>0.1</td>
</tr>
<tr>
<td>Unemployment rate</td>
<td>9.3</td>
<td>9.6</td>
<td>9.0</td>
<td>8.2</td>
<td>8.4</td>
</tr>
<tr>
<td>Inflation</td>
<td>-0.3</td>
<td>1.6</td>
<td>3.1</td>
<td>2.2</td>
<td>1.9</td>
</tr>
</tbody>
</table>

* Latest estimates used where final figures not yet available. Forecasts for 2012 and 2013 made in February 2011 and February 2012.

Source: Oxford Economics

Domestic political challenges compounded concerns over the Eurozone and resulted in 2011 growth below expectations. Questions remain over the application of the automatic debt reduction trigger and spending cuts vs tax cuts, as well as the full implementation of the Dodd-Frank Act. Clarity is needed on how the government will balance cuts with strategic investment before the private sector will commit to its own growth plans and provide much-needed job creation.

Unfortunately, some degree of uncertainty is likely to remain until after the November presidential and congressional elections, although there have been some positive economic signals early in 2012, including 2.8% GDP growth in the final quarter of 2011. Growth figures in line with or exceeding forecasts in the first quarter will provide a boost to corporate activity and job creation, as businesses look to refresh old infrastructure as well as invest for growth. They would reduce even further the likelihood of any additional quantitative easing by the Federal Reserve.

Positive economic signals could also serve as a much-needed catalyst for a sustained recovery in the housing market. As confidence improves, low mortgage interest rates should encourage buyers, and the February 2012 settlement between banks and federal and state governments will help to draw a line under the issue of improper foreclosures, as well as enabling the restructuring of existing loans. However, it remains to be seen whether the settlement will lead to more fundamental reforms of mortgage structures and processes.

Regulation vs growth?

With less exposure to the Eurozone, the overall outlook for US banks is better than for their European counterparts, but there are still some headwinds to face. The regulatory agenda marches on, though some of the regulations will remain cloaked in uncertainty until after the elections. These unknowns will hamper the US banks’ efforts to design their future business models; foreign banks may also be wary of dealing with US institutions until it is clear what responsibilities that might entail for the non-US banks.

The cost of infrastructure investments to support and comply with regulatory changes will constrain the ability of many banks to invest in growth. In this environment, and with margins compressed by low interest rates that are likely to be the norm for the foreseeable future, identifying new sources of sustainable revenue growth will be a major issue facing the industry. As a result, cost reduction, rigorous expense management and new efficiency initiatives will be paramount, especially in 2012.

However, some banks are moving carefully toward a growth agenda, though with a very measured approach to capital investment. In the short term, more focus will be on improving the productivity of existing assets, improving share-of-wallet and better understanding customer profitability across all divisions. Some US banks will be deleveraging, though on a smaller scale than their European counterparts.

Is retail banking attractive?

In retail banking, the impact of mortgage and credit card reforms and the Durbin Amendment will be extensive and will be multiplied by the launch of the Consumer Financial Protection Bureau (CFPB). Also, mortgage-related and other litigation will continue to distract and challenge some banks, further unsettling investors. Dramatically increased compliance and risk management costs for the sector will also compress earnings. It’s unclear what effect the “Occupy” movement will have, but consumer activism in general will continue to be a feature of the landscape, and banking will remain highly politicized during the 2012 election cycle.
Perhaps surprisingly, growth activity has continued and value does exist in the market for those able to carve out a differentiated niche. Competition will increase from both traditional and new sources, with further investments and acquisitions by new entrants, such as credit card companies and technology firms, as well as consolidation at the local and regional level. Mobile money will be both an opportunity and a challenge, as existing and emerging providers look for profitable ways to exploit the opportunities.

**A new look on Wall Street?**

Within corporate and investment banking, it will be less a question of consolidation and more a selective retrenching as banks adapt to the new regulatory requirements. Full-year results for 2011 highlighted the ongoing challenge for those with significant investment banking activities.

On average, banks expect that Basel III will make their market risk positions at least three times as costly in terms of capital. The over-the-counter (OTC) reforms require that margin be held for trades that were previously uncovered and that Central Counterparty Clearing Houses (CCPs) maintain capital cushions.

Subject to final wording, the Volcker Rule may impact a global bank’s revenues, additional capital obligations and risk management costs, as well as the liquidity of numerous asset classes. The proposed rule would make it extremely challenging for banks that continue operating within the trading exemptions, such as for market making and hedging.

Sales and trading activity should pick up in 2012 if the early positives are sustained and major corporations take advantage of favorable bond markets as they arise, but M&A may remain subdued until further certainty provides some cover for transactions.

Domestic banks with a market leadership position may benefit from the woes affecting their European competitors as some of those banks reduce activity or, in some cases, look to exit individual business lines altogether. However, they will face increased competition from the shadow banking sector, including broker-dealers and new loan funds. These have yet to be impacted by the regulatory reform agenda, although the collapse of MF Global is likely to have accelerated the process.

The cost of infrastructure investments to support and comply with regulatory changes will constrain the ability of many banks to invest in growth.
Although GDP growth will be lower than previously forecast, the associated reduction in unemployment should ease concerns over household debt levels. Low interest rates will help to reduce the extent of loan defaults, though more credit losses are likely in the short term, and also encourage new loan activity, particularly in the business sector.

The downside of low rates is that spreads will continue to narrow. In a market where most banks are more consumer-driven than their US counterparts, this is not great news. The outlook will be better in 2013 as rates are forecast to rise.

Retail banking will continue to be profitable but, in a highly mature market, growth will predominantly come from taking market share or selective expansion abroad – mainly the US and Latin America.

Product innovation has not been a major feature of the market but, with increased competition for domestic deposits, we may see more – particularly technology-related advances as mobile banking and mobile payment activity expands. Incumbent banks will face increasing competition from new entrants keen to exploit interest in mobile money.

Relatively low exposure to investment banking risks benefited the banks during the global financial crisis. Capital positions are strong but the mood is now more negative, affected by the dark clouds looming over the Eurozone. That sentiment is as true for business as it is for banks, and corporate banking activity will be confidence-dependent.

Compared to the recent past, we may see less domestic banking M&A activity in the next 12-24 months but, depending on where their international focus is, Canadian banks may take advantage of the sale of assets and businesses by European banks to make strategic acquisitions.

With lower levels of leverage and complexity embedded in their banking system, the Canadian regulatory focus is divided between implementing relevant G20 objectives and managing emerging extraterritorial impacts of regulation written in other countries, including the implications of the Volcker Rule for Canada’s ability to manage liquidity in its own government debt.

As the implications of the new regulatory environment and risk management requirements become clearer, Canadian banks will also see cost pressures increase significantly. Additional restructurings are likely as banks adjust their operating models and also prepare themselves for an unpredictable 2012.

<table>
<thead>
<tr>
<th>Canada</th>
<th>2009</th>
<th>2010</th>
<th>2011*</th>
<th>2012 forecast</th>
<th>2013 forecast</th>
</tr>
</thead>
<tbody>
<tr>
<td>Real GDP growth</td>
<td>-2.8</td>
<td>3.2</td>
<td>2.3</td>
<td>3.0</td>
<td>2.0</td>
</tr>
<tr>
<td>Policy interest rate</td>
<td>0.4</td>
<td>0.6</td>
<td>1.0</td>
<td>2.9</td>
<td>1.0</td>
</tr>
<tr>
<td>Unemployment rate</td>
<td>8.3</td>
<td>8.0</td>
<td>7.5</td>
<td>7.4</td>
<td>7.6</td>
</tr>
<tr>
<td>Inflation</td>
<td>0.3</td>
<td>1.8</td>
<td>2.9</td>
<td>1.8</td>
<td>2.0</td>
</tr>
</tbody>
</table>

* Latest estimates used where final figures not yet available. Forecasts for 2012 and 2013 made in February 2011 and February 2012.
Source: Oxford Economics
Those international banks with an established presence will benefit from the withdrawal of others, but face much more increased competition from local banks.

Brazil

<table>
<thead>
<tr>
<th>Brazil</th>
<th>2009</th>
<th>2010</th>
<th>2011*</th>
<th>2012 forecast</th>
<th>2013 forecast</th>
</tr>
</thead>
<tbody>
<tr>
<td>Real GDP growth</td>
<td>-0.3</td>
<td>7.5</td>
<td>2.9</td>
<td>5.5</td>
<td>5.2</td>
</tr>
<tr>
<td>Policy interest rate</td>
<td>8.8</td>
<td>10.8</td>
<td>11.0</td>
<td>10.0</td>
<td>9.5</td>
</tr>
<tr>
<td>Unemployment rate</td>
<td>7.9</td>
<td>6.4</td>
<td>5.5</td>
<td>5.6</td>
<td>5.8</td>
</tr>
<tr>
<td>Inflation</td>
<td>4.9</td>
<td>5.0</td>
<td>6.6</td>
<td>4.3</td>
<td>4.1</td>
</tr>
</tbody>
</table>

* Latest estimates used where final figures not yet available. Forecasts for 2012 and 2013 made in February 2011 and February 2012.
Source: Oxford Economics

Brazil has not completely escaped the wider economic slowdown and the focus has switched from fighting inflation to stimulating growth. As well as encouraging investment, lower interest rates will also help to prevent any major adverse changes in non-performing loan levels as a result of a short-term rise in unemployment levels.

A growth story

The domestic banking sector is strong, with a mix of state-owned, independent and well-established foreign-owned banks. International banks without a long track record will be challenged to develop a credible presence in the market. Looking longer term, the exception to that may be those institutions, such as the Chinese banks, that are building capability to support an ever-growing base of Chinese businesses investing in Brazil and may be able to change the competitive dynamics of the market.

Local banks will continue to expand within the region and, given the lending constraints of many European companies’ domestic banks, they are also likely to strengthen relationships with this group of investors, as well as with local businesses. International banks with a strong and established presence will also benefit from the withdrawal of others in both corporate and consumer segments.

With its current dependence on revenues from commodities, the economy remains susceptible to shocks, such as a slowdown in China or a geopolitical event. However, the process of diversification into manufacturing and the service sectors continues and, in addition to rebalancing the economy, it will also create new opportunities for banks to support their international customers as well as emerging local and regional businesses.

The next couple of years will see further expansion of investment and corporate banking activities, particularly lending, cash management and trade financing activities. M&A activity slowed in 2011 but is expected to pick up, driven both by intra-region acquisitions and inbound activity from foreign players attracted by the long-term growth prospects of the region. Infrastructure development to support the football World Cup in 2014 and the Olympics in 2016 continues apace, and demand for capital funding will far outstrip the supply by local banks, creating further opportunities for foreign banks with the right credentials.

On the consumer side, banks serving a growing middle class – without the memory of hyper-inflation – will see increased demand for credit and, at the top end of the market, greater expectations for more sophisticated wealth management products. Product and service offerings across the range of consumer segments, as well as customer service, should evolve over the next couple of years.

Regulation

Thanks to its response to previous crises, the Brazilian banking sector is relatively well capitalized. It also has a comparatively transparent trading environment, with nearly 100% of derivatives transactions being cleared and reported, and the regulators are more focused on standardizing a range of products.

Just as elsewhere, however, banks in Brazil are grappling with the new regulatory environment, as new requirements are introduced locally. Improving data quality will be a particular focus during the implementation phase, as will significant enhancements to operating processes. Regulation, as well as increased competition from local and international banks, will put further pressure on costs.
Europe
Regulatory unknowns remain at both an EU and UK level but a fundamental rebalancing of activities is underway as banks come under increasing pressure to simplify business models.

### UK

<table>
<thead>
<tr>
<th></th>
<th>2009</th>
<th>2010</th>
<th>2011*</th>
<th>2012 forecast</th>
<th>2013 forecast</th>
</tr>
</thead>
<tbody>
<tr>
<td>Real GDP growth</td>
<td>-4.4</td>
<td>2.1</td>
<td>0.9</td>
<td>2.6</td>
<td>0.3</td>
</tr>
<tr>
<td>Policy interest rate</td>
<td>0.6</td>
<td>0.5</td>
<td>0.5</td>
<td>1.3</td>
<td>0.5</td>
</tr>
<tr>
<td>Unemployment rate</td>
<td>7.7</td>
<td>7.9</td>
<td>8.1</td>
<td>8.0</td>
<td>8.8</td>
</tr>
<tr>
<td>Inflation</td>
<td>2.2</td>
<td>3.3</td>
<td>4.5</td>
<td>1.8</td>
<td>2.2</td>
</tr>
</tbody>
</table>

* Latest estimates used where final figures not yet available. Forecasts for 2012 and 2013 made in February 2011 and February 2012.

Source: Oxford Economics

The global financial crisis rocked the UK economy and it is struggling to recover. Although market pressures had eased thanks to an early commitment to reduce the deficit, the patience of investors and credit ratings agencies will not be unlimited, as Moody’s negative outlook has demonstrated. For the UK and its banks, the frustration will be that success or failure in the short term depends primarily on resolution of the Eurozone crisis.

Business and consumer confidence remains low and, as Ernst & Young’s ITEM Financial Services forecast highlighted, the focus is on deleveraging and saving rather than borrowing and investing. With the exception of prime property in London and the buy-to-let market nationally, recovery in the housing market will be limited. As additional austerity measures take effect and unemployment rises in 2012, we are more likely to see a short-term increase in mortgage and other loan defaults.

For smaller businesses, many are struggling to refinance existing loans as credit policies tighten and their own challenges mean that banks are unlikely to be the agents of recovery in the UK. Indeed, banks will continue their own deleveraging to shrink still-oversized balance sheets.

Large corporations are relatively cash-rich but, even if opportunities exist, they will be reluctant to place big strategic bets during such economic turbulence. Those that are looking for funding may be able to borrow more cheaply than the banks, and we will see increased use of the capital markets. For those looking for funding outside the capital markets, disintermediation of the banks is an increasing threat, as new loan funds and other funding vehicles provide alternatives to banks.

**Regulation forces change**

Legislation is still being drafted to enact the recommendations from the Independent Commission on Banking’s final report and for OTC derivatives reforms, but ring-fencing requirements are expected as part of the former and market restructuring as part of the latter. Banks may have some flexibility to determine which activities sit inside the ring-fence, but all will be facing changes to legal entity structures, organizational charts, business strategies, capital and liquidity management. Given the Financial Services Authority (FSA) Recovery and Resolution Plan timelines, banks have months rather than years to make these strategic choices.

The costs and sheer scale of implementation could be overwhelming for some; the more challenged organizations will cut back or exit completely from non-core business lines and jurisdictions. Declining revenues are likely to force further restructuring, and investment programs will be scaled back or slowed down. As well as further eroding the competitive position of some, the resulting project fatigue will be a serious consideration, especially in the control functions.

**A new battleground**

For those exiting some of the higher risk or higher capital business lines, transaction banking is seen as the new battleground for corporate client work. Increased competition in this area will place further pressure on banks to improve scalability and efficiency at a time when there is little money to fund platform and technology investments.

The retail banking market is mature, concentrated and broadly consolidated. Sales related to government bail-outs and a few new entrants (including non-traditional banks) may cause some changes to the landscape, but this will be limited in the short-to-medium term. Funding and liquidity pressures are more likely to bring changes, forcing some banks to exit profitable business lines such as consumer finance.
At the top end of retail, competition will increase in the mass affluent and high net worth segments as banks focus more resources on less risky groups and business lines that demand less capital. Banks will also experiment further with mobile money across all segments but, in common with other markets, the challenge will be converting the opportunity into a profitable one and targeting different segments with a proposition to encourage switching from other channels.

Perhaps the one optimistic note for banking in the UK will come from a global recovery that foreruns the domestic turnaround. Banks serving the multinational corporations headquartered in the UK should see that area of corporate and investment banking activity pick up ahead of local business. For the (fewer) banks that remain competitive in this area, less volatile markets and less risk aversion will be good news.

**Eurozone**

<table>
<thead>
<tr>
<th>Eurozone</th>
<th>2009</th>
<th>2010</th>
<th>2011*</th>
<th>2012 forecast</th>
<th>2013 forecast</th>
</tr>
</thead>
<tbody>
<tr>
<td>Real GDP growth</td>
<td>-4.2</td>
<td>1.8</td>
<td>1.6</td>
<td>1.7</td>
<td>-0.4</td>
</tr>
<tr>
<td>Policy interest rate</td>
<td>1.1</td>
<td>1.0</td>
<td>1.2</td>
<td>2.3</td>
<td>0.6</td>
</tr>
<tr>
<td>Unemployment rate</td>
<td>9.6</td>
<td>10.1</td>
<td>10.1</td>
<td>9.6</td>
<td>11.0</td>
</tr>
<tr>
<td>Inflation</td>
<td>0.3</td>
<td>1.6</td>
<td>2.7</td>
<td>1.8</td>
<td>2.0</td>
</tr>
</tbody>
</table>

* Latest estimates used where final figures not yet available. Forecasts for 2012 and 2013 made in February 2011 and February 2012.

Source: Oxford Economics

Fears of a credit crunch were somewhat eased when the European Central Bank (ECB) launched an unprecedented three-year long-term refinancing operation (LTRO) in December 2011, lending US$646 billion (€489 billion) to 523 banks at 1.0% interest. Combined with the second LTRO at the end of February 2012, in which 800 banks borrowed US$699 billion (€530 billion), most Eurozone banks should be able to cover their debt maturities for 2012 and 2013. Liquidity buffers have been increased and many have used the funds to swap short-term loans for longer-term ones, though it remains unclear what proportion of the funds will be made available for lending to customers.

The broader outlook for the Eurozone, and the banks within it, will depend almost exclusively on when and how the crisis ends. A second bailout for Greece has been agreed upon and yields on Spanish and Italian sovereign bonds seem to be falling, partly due to domestic banks using some of their LTRO funds to buy the sovereign debt. Progress is also being made on ratifying the treaty, signed in March 2012, that establishes a new fiscal compact for the Eurozone countries and other EU states (apart from the United Kingdom and the Czech Republic).

However, the austerity measures being implemented in Greece and across the Eurozone, though much needed, are extremely challenging. If successful, they will deliver long-term benefits, but that success is far from certain. In the short to medium term, there remains a question about whether governments have struck the right balance between reducing their deficits and stimulating growth.

The outlook for countries within the currency bloc will remain starkly different until the reforms work. Greece’s GDP shrunk by 6% in 2011, much worse than the anticipated 3.8% reduction, and 2012 will see further contraction. Contrast that with Germany where, although the economy will slow in 2012, it grew at 3% in 2011 and unemployment fell.

Concern remains that the European Stability Mechanism (ESM), due to replace the European Financial Stability Fund (EFSF) in July 2012, needs more funds at its disposal than the planned €500 billion to provide an effective firewall against future shocks. There is also the prospect of further sovereign debt and bank downgrades by the ratings agencies. A break-up of the Eurozone remains highly unlikely but the absence of a resolution that is durable and credible in the eyes of markets and investors leaves room for unhelpful speculation.

In the face of all this, consumers and companies will continue to deleverage and Eurozone output is expected to shrink further in the early part of 2012. Conditions are not favorable for investment and expansion, with companies either sitting on cash or unable to access funding.
From funding challenge to capital challenge

The ECB's LTRO may have eased funding pressures for the banks and it may also help to dampen a damaging war for deposits among the banks. However, we may see a continued outflow of deposits in some markets, as retail and business customers remain anxious.

The next challenge for many banks will be meeting the new 9% core tier-one capital requirement established by the EBA. The EBA’s December 2011 stress test results showed that EU banks face an aggregate capital shortfall of €114.7 billion, with 31 banks required to increase capital levels (see Chart 6 for breakdown by country).

Chart 6. Capital shortfall by country (€ billion)

<table>
<thead>
<tr>
<th>Country</th>
<th>Capital Shortfall (€ billion)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Greece</td>
<td>30,000</td>
</tr>
<tr>
<td>Spain</td>
<td>26,170</td>
</tr>
<tr>
<td>Italy</td>
<td>15,366</td>
</tr>
<tr>
<td>Germany</td>
<td>13,107</td>
</tr>
<tr>
<td>France</td>
<td>7,324</td>
</tr>
<tr>
<td>Portugal</td>
<td>6,950</td>
</tr>
<tr>
<td>Belgium</td>
<td>6,313</td>
</tr>
<tr>
<td>Austria</td>
<td>3,923</td>
</tr>
<tr>
<td>Cyprus</td>
<td>3,531</td>
</tr>
<tr>
<td>Norway</td>
<td>1,520</td>
</tr>
<tr>
<td>Slovenia</td>
<td>320</td>
</tr>
<tr>
<td>Netherlands</td>
<td>159</td>
</tr>
</tbody>
</table>

Source: European Banking Authority

Although the EBA has said that, at an aggregate level, plans to meet the capital shortfall are not over-reliant on asset sales and cuts to lending, some banks will have little alternative. Market valuations have made rights issues extremely difficult and retained earnings will not be enough to fill the gap. Estimates of assets for sale vary but range from US$2 trillion to US$4 trillion over the next 12-18 months and up to US$4.5 trillion (10% of balance sheets) over five years. As Ernst & Young’s recent Eurozone forecast shows, an increase in loan defaults in 2012 will also put further pressure on bank balance sheets.

Sellers without buyers?

Some assets being sold will be European but political pressure, as well as scale issues and challenges accessing the US dollar funding needed for activities such as commodities trading, will see European banks scale back operations outside the region and find it increasingly difficult to compete globally.

Buyers will be scarce, however, and looking for heavily discounted prices even for relatively strong assets. While non-European assets will attract global buyers, they will be very selective about any European assets for sale.

Further consolidation among the largest Eurozone banks is unlikely — competition and systemic risk issues would prevent regulatory approval. More consolidation is likely between the small to medium-sized domestic banks, particularly in markets like Germany, Italy and Spain, where there are still many local and regional institutions that will find it increasingly difficult to prosper.

We also expect some cross-border and domestic activity in corporate and investment banking, as better capitalized banks look to exploit forced asset sales to build scale and increase competitive advantage; the future industry in Europe will be smaller.

Finding new sources of sustainable revenue growth will be a challenge until the Eurozone crisis eases and banks themselves are more structurally stable. Many European businesses are able to borrow at better rates than banks at the moment. Where corporations are looking to the banks, security will be a key concern and the national champions and G-SIBs will benefit.
Political, regulatory and economic pressures will see many European banks scale back their operations outside the region, but buyers for these assets may be scarce.

Outside the Eurozone
As the deleveraging cycle intensifies to meet the June 2012 EBA deadline, parts of Eastern Europe will face particular challenges given the foreign ownership of many of their larger banks, with assets being repatriated and loan restrictions increasing.

However, over time, this may be the catalyst required for consolidation in these markets to build “national champions.”

Regulation across the EU
Much of the European supervisory agenda in 2012 will focus on Basel III implementation. The European Banking Authority’s Work Program, published in January for 2012, includes 320 tasks, the majority of which are driven by capital and liquidity objectives.

Amendments to one of the core markets reform measures in the EU, the Markets in Financial Instruments Directive (MiFID), were published in December 2011. MiFID II sweeps a wide variety of “equity-like” products (exchange-traded funds and others), fixed-income instruments and high-frequency trading strategies into the net. It will also raise concerns over market fragmentation within the region’s financial market utility (FMU) framework and access for institutions sitting outside of the EU.

A financial transaction tax, favored by some European politicians, remains unlikely at an EU level, given the requirement for unanimity, but is still a possibility within the Eurozone. While it may not come into effect within the next two years, it is another variable that banks need to consider when analyzing their activities and operations in Europe. As discussed in Ernst & Young’s recent Eurozone FS forecast, if the financial benefits are unproven, it seems more likely that the aim is to discourage certain activities.
For Switzerland, where the economy overall and the banking system in particular have long been viewed as bastions of stability and safety, the outlook is mixed. Growth has suffered as a result of the Eurozone crisis and exporters have also been hit by the strength of the Swiss franc, dampening the outlook for the domestic corporate banking market.

The largest Swiss banks are also grappling with the additional capital requirements, the so-called “Swiss finish,” imposed by the regulator, and determining how to adapt their business models to a banking environment that will be fundamentally different both at home and abroad.

Although the reputation of private banking and wealth management globally has been tarnished and there is a renewed focus on transparency as part of the global regulatory reform agenda, Swiss banks will continue to benefit from a reputation for safety and security in a time of economic and political uncertainty. Foreign banks will also continue to develop and expand their presence in the market through both organic and inorganic growth.

The increasing wealth of individuals in many of the rapid-growth economies will be another source of optimism for the sector. Banks will continue to expand their coverage into these markets, particularly in Latin America and the Middle East, where high net worth individuals often favor Switzerland as a booking center for their assets.

The emergence of Hong Kong and Singapore as leading wealth management centers in Asia may be competition for Switzerland, but Swiss banks will continue to build out their capability in the region and offer clients an alternative booking center to Switzerland.

<table>
<thead>
<tr>
<th>Switzerland</th>
<th>2009</th>
<th>2010</th>
<th>2011*</th>
<th>2012 forecast</th>
<th>2013 forecast</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td></td>
<td></td>
<td></td>
<td>Feb 2011</td>
<td>Feb 2012</td>
</tr>
<tr>
<td>Real GDP growth</td>
<td>-1.9</td>
<td>2.7</td>
<td>1.8</td>
<td>1.9</td>
<td>0.3</td>
</tr>
<tr>
<td>Policy interest rate</td>
<td>0.3</td>
<td>0.2</td>
<td>0.1</td>
<td>2.2</td>
<td>0.1</td>
</tr>
<tr>
<td>Unemployment rate</td>
<td>4.2</td>
<td>3.5</td>
<td>3.1</td>
<td>2.9</td>
<td>3.4</td>
</tr>
<tr>
<td>Inflation</td>
<td>-0.5</td>
<td>0.7</td>
<td>0.2</td>
<td>1.0</td>
<td>-0.3</td>
</tr>
</tbody>
</table>

* Latest estimates used where final figures not yet available. Forecasts for 2012 and 2013 made in February 2011 and February 2012.
Source: Oxford Economics
Asia Pacific
Japan

A recovering economy but with challenging fundamentals

<table>
<thead>
<tr>
<th>Japan</th>
<th>2009</th>
<th>2010</th>
<th>2011*</th>
<th>2012 forecast</th>
<th>2013 forecast</th>
</tr>
</thead>
<tbody>
<tr>
<td>Real GDP growth</td>
<td>-5.5</td>
<td>4.5</td>
<td>-1.0</td>
<td>2.0</td>
<td>2.0</td>
</tr>
<tr>
<td>Policy interest rate</td>
<td>0.1</td>
<td>0.1</td>
<td>0.1</td>
<td>0.7</td>
<td>0.1</td>
</tr>
<tr>
<td>Unemployment rate</td>
<td>5.1</td>
<td>5.1</td>
<td>4.6</td>
<td>4.9</td>
<td>4.3</td>
</tr>
<tr>
<td>Inflation</td>
<td>-1.3</td>
<td>-0.7</td>
<td>-0.3</td>
<td>0.5</td>
<td>0.1</td>
</tr>
</tbody>
</table>


Following the earthquake and tsunami in March 2011, the supply chain has now recovered and reconstruction is underway. As the rebuilding efforts continue, demand for funding will grow and this is likely to boost corporate lending activity in the short term. It is also hoped the Bank of Japan’s decision to increase its asset purchase program will further stimulate growth.

Unfortunately, this good news will be somewhat offset by the yen’s appreciation and the ongoing Eurozone crisis – both of which will be problematic for manufacturers looking to export. They expect 2012 to be challenging, according to The Bank of Japan’s December 2011 Tankan Survey, reducing appetite for investment. Low interest rates will also continue to adversely affect banking margins.

In the longer term, the decreasing population does not bode well for the domestic economy. Businesses will look to growth opportunities abroad and move more of their manufacturing capacity offshore and there will be limited domestic growth opportunities for consumer banking.

Banks looking abroad for growth

Japanese banks are generally well capitalized and have limited direct exposure to the Eurozone. Those looking abroad will be well-placed to take advantage of asset and business sales by stressed European banks. Their primary focus is likely to remain Australia, Brazil and the Asia-Pacific rapid-growth economies.

Smaller banks will focus mainly on supporting their Japanese clients as they expand abroad and shift focus to non-domestic markets, wary of building up too much exposure to local businesses in markets where they’re still building expertise. There will be increasing demand for this support, as Japanese companies continue to expand through foreign acquisitions.

Although the Japanese banks emerged comparatively unscathed from the global financial crisis, the country is home to three of the G-SIFIs and the government has signed up to implement the G20’s new global regulatory standards. Large banks in Japan will be grappling with a range of reforms, including Basel implementation, resolution planning and OTC derivatives.

Asset concentration is also a concern for the Japanese banks, with the 39% of domestic government debt that they hold representing 25% of their combined balance sheets (Bank of Japan, as of September 2011).

The additional costs associated with more aggressive regulation will place a further burden on the profitability of domestic operations and we’re likely to see further consolidation among the smaller and medium-sized banks to improve market share and efficiency.

Technology investment is also likely to increase, to support regulatory compliance and cost reduction and also to provide customers with new products and services in the hope of increasing market share in this highly saturated market. Although there has been some mobile payments activity for a few years, internet and mobile banking continue to evolve in Japan and the scope for development is significant.

Both Japanese corporations and the banks that support them will continue to look abroad in search of growth.
Still two stories

Australia remains characterized by a multi-speed economy. The mining sector continues to boom (as long as China doesn’t slow too much) but many other sectors are exposed to low growth and high labor costs.

The Reserve Bank of Australia’s rate cuts late last year may help to improve consumer and corporate confidence, though banks may be reluctant to reduce their interest margins and pass on any future cuts as they struggle with their own funding and costs.

The expected increase in consumer saving levels will help to reduce the high household debt burden, as well as provide more stable funding for the banks. The decision by the Australian Prudential Regulation Authority (APRA) to allow the use of covered bonds will also help, but the banks will still need to access the offshore funding market and will remain somewhat dependent on the appetite of international investors.

In response to restricted bank lending, we have started to see superannuation funds providing capital and loan funding to support real estate development projects. How strong this trend will be remains unknown, but disintermediation of the banks is a risk here as well as elsewhere.

Looking abroad for growth

The Australian government’s four pillars policy restricts the scope for any major consolidation among the four major banks so, in such a mature banking market, domestic retail banking growth opportunities are limited. As with other markets, capital markets and corporate lending activity will also remain subdued until confidence improves. Businesses are sitting on cash piles but wary of making big strategic bets.

The exception to this is in mining and related sectors. Absent a major shock, banks working in these industries should continue to see strong corporate activity, as well as further M&A business, although the large deals may continue to elude. Foreign banks will also pursue more business here, looking to support their domestic corporate clients as they expand.

Driven by these limited home-market opportunities, most Australian banks will continue to look at international expansion for the next phase of growth.

<table>
<thead>
<tr>
<th>Australia</th>
<th>2009</th>
<th>2010</th>
<th>2011*</th>
<th>2012 forecast</th>
<th>2013 forecast</th>
</tr>
</thead>
<tbody>
<tr>
<td>Real GDP growth</td>
<td>1.4</td>
<td>2.6</td>
<td>1.9</td>
<td>4.2</td>
<td>3.1</td>
</tr>
<tr>
<td>Policy interest rate</td>
<td>3.3</td>
<td>4.4</td>
<td>4.7</td>
<td>5.6</td>
<td>3.9</td>
</tr>
<tr>
<td>Unemployment rate</td>
<td>5.6</td>
<td>5.2</td>
<td>5.1</td>
<td>4.8</td>
<td>5.5</td>
</tr>
<tr>
<td>Inflation</td>
<td>1.8</td>
<td>2.8</td>
<td>3.5</td>
<td>2.5</td>
<td>2.0</td>
</tr>
</tbody>
</table>

* Latest estimates used where final figures not yet available. Forecasts for 2012 and 2013 made in February 2011 and February 2012.
Source: Oxford Economics
China

The Chinese growth story continues, though the juggernaut has shown some signs of slowing as a result of events in the US and Europe. The Chinese government is cautiously loosening monetary policy, and bank reserve requirements were relaxed slightly toward the end of 2011 and again in February 2012 to boost lending capacity. However, liquidity controls remain tight, and there is further scope to stimulate growth and avoid a hard landing should that be required.

In response to the global financial crisis, the government encouraged banks to lend to local government financing vehicles for infrastructure projects. Banks also have considerable direct exposure to real estate loans, and there is concern about the default risks and falling real estate prices.

Under instruction from the China Banking Regulatory Commission (CBRC), banks have completed three rounds of stress tests. Results indicated that risks are manageable and problems can be withstood by the banks at an aggregate level. As an additional measure, further restrictions have been placed by the CBRC on new loans or refinancing to developers. A major correction is not currently expected but, if it does happen, banks with additional exposure to related industries (e.g., steel, other raw materials) will be more at risk.

The banks remain well-capitalized by international standards and, over the short-to-medium term, they will continue to diversify their loan portfolios to reduce the concentration risk on real estate and increase focus on entrepreneurs. As the economy matures and domestic demand increases, new products will also reduce reliance on interest income. Opportunities will emerge in corporate (cash management, trade financing) and consumer banking (credit cards, loans, private banking), as well as in the burgeoning investment banking sector (primarily debt and equity capital markets, M&A, bridge financing).

Chinese banks will strengthen efforts to increase market share in Hong Kong and selectively expand their international coverage, supporting major corporate clients as they invest and expand abroad. As we have seen to date, this growth will take the form of small organic operations or minority stakes in other banks, rather than full-scale acquisition.

Conversely, restrictions on foreign bank ownership and investment in China will continue for the foreseeable future, making the market challenging enough for those that already have a credible presence and near impossible for those that don’t. Established international banks will continue to invest and strengthen their market position, but this is a longer-term game.

Regulatory environment – strong and tough
Chinese banks incurred few direct losses in the global financial crisis and the banking sector in China remains less complicated and better capitalized than in other financial centers. Yet the CBRC has committed to implementing Basel III and implementation rules have been available for some time.

The CBRC has also recently made additional advances to bolster banks by restricting certain off-balance sheet vehicles that were rising in popularity and imposing a rigorous stress-test program on the large banks.

Authorities announced early in 2012 the creation of a bureau to protect investor interest and streamline the complaints process. Additionally, the industry expects the government to establish another new regulator to oversee state-owned financial assets.

<table>
<thead>
<tr>
<th>China</th>
<th>2009</th>
<th>2010</th>
<th>2011*</th>
<th>2012 forecast</th>
<th>2013 forecast</th>
</tr>
</thead>
<tbody>
<tr>
<td>Real GDP growth</td>
<td>9.2</td>
<td>10.4</td>
<td>9.2</td>
<td>9.0</td>
<td>8.4</td>
</tr>
<tr>
<td>Policy interest rate</td>
<td>1.8</td>
<td>1.8</td>
<td>2.3</td>
<td>4.2</td>
<td>2.3</td>
</tr>
<tr>
<td>Unemployment rate</td>
<td>4.3</td>
<td>4.2</td>
<td>4.1</td>
<td>4.2</td>
<td>4.0</td>
</tr>
<tr>
<td>Inflation</td>
<td>-0.7</td>
<td>3.3</td>
<td>5.4</td>
<td>2.9</td>
<td>2.9</td>
</tr>
</tbody>
</table>

* Latest estimates used where final figures not yet available. Forecasts for 2012 and 2013 made in February 2011 and February 2012.
Source: Oxford Economics
The Reserve Bank of India (RBI) has had little flexibility to stimulate growth, with inflation still north of 9% and a currency that fell almost 20% against the dollar in 2011. It should have more room to maneuver over the next two years and cheaper credit will stimulate consumer spending and business investment. Lower interest rates may also help to alleviate the risk of rising levels of bad debt, which prompted Moody's to downgrade the outlook for India's banking system in November 2011.

Reforms, such as those that allow non-financial Indian companies to establish banks and the deregulation of deposit interest rates, will also help by increasing domestic competition in banking over the medium to long term. However, further reforms are needed to facilitate infrastructure development and encourage much higher levels of corporate investment.

The protectionist policy favoring domestic banks shows no sign of easing and significant expansion by foreign banks in India will continue to be difficult; new foreign banks may be allowed entry but they will struggle to amass many licenses for branch expansion, and restrictions on corporate and investment banking activities will continue.

Foreign banks, operating as branches rather than local subsidiaries, have also been at a significant tax disadvantage compared to their Indian competitors. Recent tax reforms have been designed to incentivize banks to establish subsidiaries, but further work is needed to clarify the benefits.

At the top of the regulatory agenda, anti-corruption legislation should benefit public sentiment and business conditions. The Government has also relaxed the rules to allow foreigners to invest directly in Indian equity markets, which should increase the availability of funds for investments – though businesses borrowing abroad will suffer if the currency continues to depreciate.

RBI’s mandate on financial inclusion will continue to drive innovative low-cost services in rural markets, and banking using mobile devices will expand further and faster here than in many developed markets. In business banking too, mobile banking technology will be used to improve service delivery and access to transaction data.

The potential of the Indian market makes it extremely attractive for international banks but, given the challenges that remain, the benefits of investment may only be realized over a longer-term period.
Indonesia

Although Indonesia has been somewhat affected by issues in Europe and the US, GDP growth has remained strong and Indonesia’s debt returned to investment-grade status for the first time in 14 years in December 2011.

Fueled at least in part by lower interest rates, business plans submitted by banks to Bank Indonesia suggest credit growth will be over 20% in 2012. A strong mining sector will continue to boost commercial demand, and the passage of the Land Acquisition Bill in December 2011 has cleared the way for much greater infrastructure development, which will further stimulate private sector investment, as well as direct demand for project financing.

The continued growth of the middle class and the increasing proliferation of smartphones will create new opportunities for consumer banking products, delivered via mobile technology to obviate the requirement for an extensive and costly branch infrastructure.

As with other parts of Asia and the Middle East, Sharia-compliant banking products will be a growth opportunity in Indonesia, as the Muslim sector of the population grows richer. Ernst & Young’s World Islamic Banking Competitiveness Report forecasts that global Islamic banking assets with commercial banks will reach US$1.1t in 2012. However, the demand for these products to be provided by established global banks is difficult to predict and local and regional banks may enjoy more success in this market and elsewhere.

In 2013, a new integrated financial services regulator will take over the supervision of banks, brokerages and insurance firms from the central bank and the capital markets regulator.

All of this is good news for the banking sector, but political and economic risks remain. Under the current rules, foreign banks can own up to 99% of Indonesian banks, and this relatively open market has encouraged both global and regional institutions to invest.

With local banks focused on retail customers, foreign institutions have developed a significant presence in wholesale and corporate banking. However, pending regulatory changes could restrict foreign ownership of banks from the current level of 99% to less than 50%. This is still a proposal and may not happen, but the uncertainty will be unsettling for existing and prospective investors.

---

<table>
<thead>
<tr>
<th>Indonesia</th>
<th>2009</th>
<th>2010</th>
<th>2011*</th>
<th>2012 forecast</th>
<th>2013 forecast</th>
</tr>
</thead>
<tbody>
<tr>
<td>Real GDP growth</td>
<td>4.6</td>
<td>6.2</td>
<td>6.5</td>
<td>6.5</td>
<td>6.2</td>
</tr>
<tr>
<td>Policy interest rate</td>
<td>6.9</td>
<td>6.5</td>
<td>6.6</td>
<td>7.5</td>
<td>6.2</td>
</tr>
<tr>
<td>Unemployment rate</td>
<td>7.9</td>
<td>7.1</td>
<td>6.3</td>
<td>5.9</td>
<td>5.9</td>
</tr>
<tr>
<td>Inflation</td>
<td>4.8</td>
<td>5.1</td>
<td>5.4</td>
<td>5.4</td>
<td>4.6</td>
</tr>
</tbody>
</table>

* Latest estimates used where final figures not yet available. Forecasts for 2012 and 2013 made in February 2011 and February 2012. 
Source: Oxford Economics
Contacts

Bill Schlich  
Global Banking & Capital Markets Leader  
New York  
william.schlich@ey.com  
+1 212 773 3233

Ian Baggs  
Deputy Banking & Capital Markets Leader  
London  
ibaggs@uk.ey.com  
+44 20 7951 2152

Steven Lewis  
Lead Analyst  
Global Banking & Capital Markets Center  
London  
slewis2@uk.ey.com  
+44 20 7951 9471

Marcel van Loo  
EMEIA Banking & Capital Markets Leader  
Amsterdam  
amarcel.van.loo@nl.ey.com  
+31 88 407 1566

Steve Ferguson  
Asia Pacific Banking & Capital Markets Leader  
Sydney  
steve.ferguson@au.ey.com  
+61 2 9248 4518

Tadayuki Matsushige  
Japan Banking & Capital Markets Leader  
Tokyo  
matsushige-tdyk@shinnihon.or.jp  
+81 3 3503 1916
About Ernst & Young
Ernst & Young is a global leader in assurance, tax, transaction and advisory services. Worldwide, our 152,000 people are united by our shared values and an unwavering commitment to quality. We make a difference by helping our people, our clients and our wider communities achieve their potential. Ernst & Young refers to the global organization of member firms of Ernst & Young Global Limited, each of which is a separate legal entity. Ernst & Young Global Limited, a UK company limited by guarantee, does not provide services to clients. For more information about our organization, please visit www.ey.com.

About Ernst & Young's Global Banking & Capital Markets Center
In today's globally competitive and highly regulated environment, managing risk effectively while satisfying an array of divergent stakeholders is a key goal of banks and securities firms. Ernst & Young's Global Banking & Capital Markets Center brings together a worldwide team of professionals to help you achieve your potential — a team with deep technical experience in providing assurance, tax, transaction and advisory services. The Center works to anticipate market trends, identify the implications and develop points of view on relevant sector issues. Ultimately it enables us to help you meet your goals and compete more effectively. It's how Ernst & Young makes a difference.

© 2012 EYGM Limited.
All Rights Reserved.

EYG No. EK0087

This publication contains information in summary form and is therefore intended for general guidance only. It is not intended to be a substitute for detailed research or the exercise of professional judgment. Neither EYGM Limited nor any other member of the global Ernst & Young organization can accept any responsibility for loss occasioned to any person acting or refraining from action as a result of any material in this publication. On any specific matter, reference should be made to the appropriate advisor.