Time for bold action
Global banking outlook 2013-14
When we issued our first global banking outlook in March 2012, there was little doubt that the environment would be a difficult one for banks. For European institutions in particular, expectations were weighted very much toward the negative. Even in the rapid-growth markets (RGMs), a slowdown in China and lower domestic growth forecasts were causes for concern.

Fast forward to the end of 2012 – the prospects are better but not great. Retail and small business customers still have limited trust in the banking industry. Further examples of regulatory and compliance breaches during the course of this year have done little to shift that opinion. Large corporations remain wary of committing to significant investment, and many are sitting on major cash reserves.

The regulatory landscape may be less opaque now, but it is certainly no less challenging. Some aspects of the change agenda remain unknown, and there is a worrying shift toward a more nationalist approach by supervisors across a range of jurisdictions.

However, consumer confidence is slowly returning in the US, and GDP growth is heading back toward pre-crisis levels across a range of RGMs. As we look ahead to 2013 and 2014, the outlook for banks will depend partially on their location and their customer base. Of course, it will also hinge on the decisions that banks make over the coming months and years.

For some, the focus will be on positioning themselves to benefit from the next wave of explosive growth; for others it will be a case of repositioning for survival. The drivers for change may be different, but banks in both camps should be looking at a fundamental reshaping of their business and operating models. Many banks will not adapt successfully to the new environment through incremental shifts; instead, bold and decisive action is needed.

As banks consider their options, every aspect of the organization will come under scrutiny. Although the task is daunting, examining all of these components together provides banks with an opportunity to reshape the whole organization rather than embarking on multiple, potentially disjointed change projects.

In this edition of the outlook, we’ve outlined the issues, challenges and opportunities for what we believe will be the 10 key components for banks to consider. We hope you find it useful, and we very much look forward to any feedback you may have.

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European policy-makers have agreed to the broad outlines of a roadmap to deliver a banking union for the currency bloc that should break the feedback loop between sovereigns and banks. However, protracted negotiations suggest that the precise elements of the union, as well as the timetable for its full implementation, will be unclear for some time to come.

The prospect of a hard landing in China amplified concerns over the world economy, and a slowdown across the RGMs further damaged confidence levels. Although growth slowed, it appears to have been a softer landing than feared, and there are signs that the economy is starting to rebound. The new leadership will want to start on a positive note, but concerns remain over the property market, loans to municipalities and the potential impact of further problems in the US and Europe on China’s recovery.

In the US, the recovery has been slow but positive, although investment activity slowed down in the run-up to the elections. The results provide some clarity but little certainty on whether the worst effects of the fiscal cliff will be averted. Any temporary measures aside, negotiations between President Barack Obama and Congress need to deliver a credible long-term deficit reduction plan and avoid the politics that surrounded the previous raising of the debt ceiling.

If the fiscal cliff is avoided and there are no further shocks in Europe or China, the world economy is expected to rebound slowly in 2013 and recover more strongly to 3.6% GDP growth in 2014. However, wary of further setbacks, many businesses and consumers will remain uncertain for some time and be reluctant to commit to major spending and investment decisions.

Banks across many developed markets remain undercapitalized and are unwilling, or unable, to write down asset values to more realistic levels and accept credit losses. Many of those same banks will also face the challenge of weaning themselves off central bank liquidity support before the repayment deadlines. The economic recovery will alleviate some of these problems, but further bank restructuring is likely in the short to medium term.

Banks in rapid-growth economies are broadly well-capitalized and focused more on growth than restructuring. Yet the recent
credit boom will leave some vulnerable to rising default rates as these markets shake off the effects of the global slowdown. Competitive pressures are intensifying, and growing pains are likely following a period of rapid expansion.

Compounding the impact of a sluggish economic recovery, particularly in Europe, is the still-evolving regulatory environment. It is clear the reforms will fundamentally reshape the banking industry, but many rules remain unwritten and the timetable for completion varies across jurisdictions. Uncertainties around requirements in areas such as resolution planning, over-the-counter derivatives reform and structural reforms will complicate banks’ approaches to how they structure their global business activities going forward.

Causing further concern is the tendency of regulators to adapt globally agreed minimum standards, often “gold-plating” requirements, and to take a protectionist stance. Although understandable, it makes the task of developing new business models and implementing new operating models that much more complex and expensive for the banks. It also has the potential to damage global growth prospects.

Regardless of location or position, it’s a critical time for the banks. Decisions taken now will determine how well they are positioned to benefit from the recovery in developed markets, the new regulatory landscape and the next wave of expansion in the RGMs.

Those decisions must result in a credible story for internal and external stakeholders. They also must result in a sustainable business model that delivers a return on equity (ROE) that exceeds its cost.

There will be many components of the existing model to review and, because most are interconnected, the successful banks will be those that consider them together and make bold decisions across the organization.

In this edition of the Outlook we’ve outlined the issues, challenges and opportunities for what we believe will be the 10 key components for banks to consider.
1. Environment – accept, adapt

Sub-10% ROEs offer a stark reminder of the challenges facing many banks, but even where that metric is still healthy, external factors such as persistently low interest rates are disrupting business models. Customers are also disturbing the status quo – they continue to need banking services but are starting to look beyond banks to alternative providers. Retail and technology firms will continue to capitalize on this.

Banks are recognizing that incremental change is no longer a viable response to the seismic shift facing the industry. A major overhaul of the organization will be needed to adapt to the new environment. A few banks have already announced bold repositioning strategies, but many more need to follow. Balancing multiple priorities, it will be crucial for senior management to devote enough time to the future and not be swamped by legacy issues.

Some brands will disappear as consolidation intensifies among sub-scale banks. In Europe, many that survive will be much smaller as deleveraging is expected to shrink balance sheets by more than USD2.5 trillion by December 2013. At the same time, pension funds and insurance companies are desperate for higher yields to offset low interest rates, so we see more collaboration taking place to marry their balance sheets with the capabilities and client base of the capital-constrained banks.

As subsidiaries are sold and branches closed, the ability to serve international customers will be at risk. However, this will present an opportunity for some to innovate, potentially partnering with other banks facing similar challenges in different locations or cooperating with local banks in new markets. Banks also can learn from the experience of other sectors and we expect the more innovative institutions to follow the example of media and utility firms, who share infrastructure.
2. Reputation — restore, protect

If the first step is to appreciate the scale of change affecting the industry, a close second is to recognize the poor state of its reputation. Although customers are broadly satisfied with their banking relationships, the industry as a whole remains tarnished by the events of the last few years. Further regulatory and compliance issues in 2012, such as LIBOR and anti-money laundering, and the slow pace of reform within banks have provided further ammunition for critics.

Banks also need to restore their reputation with investors. Developing and delivering on a future strategy that is credible is a start. Implementing compensation models that encourage a longer-term view and recognize a lower-return environment will further improve shareholder relations as well as shareholder returns.

Going forward, the reputation lens is going to be an ever-more prominent filter for banks as they adapt their organizations to the new environment. Some banks are already talking openly about restoring their reputations and taking steps to reduce the scope for future damage. Others will follow a similar approach as current models are overhauled during the next few years. Assessing new product opportunities in the context of public perception, shareholder benefit and reputational risk should become the norm.

The industry also needs to shift from a reactive to a proactive stance. Demonstrating the crucial role that banks play as intermediaries for businesses and institutional investors such as pension funds will help. So will improving the approach to managing business conduct and assessing customer suitability before another compliance breach forces change.

3. Culture, behavior, reward — alignment

For many banks, the scale of the transformation required will resemble the turnaround of a business in distress. Restoring their reputation may address problems with external stakeholders, but the challenge of change will require significant internal efforts as well.

The industry has a reputation of over-compensating in some areas, jumping from rapid expansion to drastic cuts. Adapting the organization to the realities of the new environment will involve cuts, but more nuanced changes, such as a shift in behavior, will also be crucial.

Boards and senior management recognize that a cultural shift is required. However, more of them need to articulate and communicate a vision for the future that is relevant and motivating to staff, particularly given the restructuring initiatives to cut costs and personnel. This will be crucial in the coming months and years as more key employees suffer from project fatigue. We should also see much more attention paid to managing potential conflicts in behavior between different parts of the business.

Restructuring compensation models should be part of that behavioral alignment process, as some firms are already demonstrating. The balancing trick over the coming months will be to deliver a new approach that reflects the financial realities of the organization yet also provides enough of a long-term incentive to protect the franchise in high-risk areas.

4. Customer — requirements, expectations

Businesses and consumers may still be wary about spending and investing, but the changes to the customer landscape go beyond the cyclical and beyond reputational issues. The structural dynamics across segments are also changing. As banks look to effect behavioral change within their organizations, they should incorporate shifting customer requirements and expectations into this culture-changing process.

Traditional banks also need to expend greater effort to engage successfully with customers, including via social media. Compared to new, alternative providers, they have had limited success to date, but we expect more to invest in building a credible presence on these channels to move beyond corporate feeds and sponsored advertisements. However, agile organizations, free from lumbering bureaucracy, will be more likely to succeed.
As sales and service delivery models come under review, banks should also be exploring how to translate some of the consumer-focused mobile applications into new solutions for business customers — both small and medium-sized enterprises (SMEs) and major corporations. These innovations will strengthen relationships, but credit provision will remain fundamental to protecting the corporate banking franchise.

Undercapitalized banks will face difficult choices as they look to deleverage, but their future business model may need to exist without that franchise if they impose short-term restrictions on customer credit facilities.

5. Product mix/product dilemma
Margin compression is becoming a feature across banking markets as regulation, capital requirements, funding costs, lackluster demand, low interest rates, price competition and shifting buying patterns all affect profitability. Scale or niche expertise is increasingly crucial and, as we’ve seen already, so are customer expectations.

With cost-income ratios in excess of 80% for some, tough decisions can no longer be deferred. Over the coming months and years, we will see more banks scale back their global footprint and reduce their product portfolio. And in capital-intensive areas such as fixed income and commercial real estate, we’ll also see cuts to wealth management capabilities as low returns and increasingly intense competition deter those without a strong reputation.

To some degree, these decisions will be more of an art than a science as banks try to predict where the strongest future revenue opportunities will materialize and outguess each other on which areas to cut. It will be survival of the strongest, but some will also be lucky. Agreements or partnerships with third parties, such as pension funds but also other banks, are also likely to increase as banks strive to maintain full-service capabilities.

Those that are based or invested in the RGMs will face a more optimistic future. Net interest income is being squeezed and non-performing loans are creeping up in some cases, but the growth potential from new and existing customers is significant in both conventional and Islamic banking products. On the corporate side,
the capital markets will continue to develop to support business expansion and infrastructure investment (the Asian Development Bank predicts USD8 trillion over the next 10 years). More local banks will strive to emerge as regional leaders, and we can expect further build-out of their capabilities and their footprint as they exploit domestic and international trade-flow opportunities.

6. Pricing – old challenges, new models
The increased cost of securing funds to lend is being compounded by the additional capital charges imposed under Basel III and the emergence of binding liquidity and leverage requirements. At the same time, customer behavior is changing and expectations are increasing.

Multinational corporations understand the challenges facing the banks, but they’re also looking for unwavering commitments to credit provision and pricing models that are consistent across markets. Capital- and liquidity-constrained banks will find those demands increasingly difficult to meet. Conversely, those that can invest in developing their data models will be able to use more effective allocation and pricing of capital and liquidity to differentiate their product offerings to clients.

Pricing models for retail customers vary considerably across markets, and many customer pricing models are still dependent on cross-selling assumptions. However, regardless of the exact pricing model, most consumers are unhappy with the current approach and, with more customers becoming multi-banked, those old models will cease to add up.

There is a clear opportunity for differentiation. Might one organization step up to offer a groundbreaking “new deal”? As competition intensifies across markets, customers become less loyal and alternative providers enter the market, there is a clear opportunity for differentiation. Might one organization step up to offer a groundbreaking “new deal,” and will that organization be a bank, a retailer or a technology firm?
Executive summary

7. (Re)Structure
As banks adapt to the new environment, many operating models and structures are no longer suitable. Previous incremental changes must now give way to more fundamental restructuring. In some cases, old structures will be too expensive and too complicated for a much simpler future business model. Shrinking to fit will be a challenge, but it will also offer those banks an opportunity to dismantle bureaucratic silos that may impede adoption of a single culture.

In other cases, rapidly expanding organizations have outgrown their old operating model and will require more formal systems and procedures. Regulatory requirements will also influence future structures as supervisors expect global organizations to be much more globally connected.

Banks should treat this as an opportunity to reshape the organization to better suit their customers’ needs as well as their own. Structures that remain aligned to products and functions will not be able to support a bank’s efforts to provide customers with a more transparent, consistent and comprehensive service.

In all cases the new structure, including the customer-facing aspects and the “engine” that supports them, will need to reduce costs and deliver much-improved operating efficiency. Further outsourcing and off-shoring will continue but, conscious of concentration risk in some locations and concerns from supervisors, banks will also be exploring alternatives.

We’re likely to see more innovation emerge around in-house provision and the use of lower-cost onshore locations. In some RGMs, there’s also considerable scope to share more back office infrastructure across the industry.

8. Location – physical, virtual
Many banks that invested heavily to give themselves global scale and reach are now poised to abandon much of that footprint. Some, such as European banks under pressure to focus on core services in core markets, have already started the retreat from international corporate and investment banking activities.

As new regulations take effect, including local requirements for foreign banks to replace branches with subsidiaries, others will follow with potentially severe consequences for their corporate banking franchises. The proposed European Financial Transaction Tax may further damage banking in the region. As some international banks retreat from the RGMs, the gaps will increasingly be filled by domestic and regional banks, further expanding their international capabilities and following their corporate customers into new markets.

For retail banking, branch networks will see significant expansion across the RGMs, particularly in major population centers. Elsewhere, ATM technology will be leveraged to provide “automatic” branches. And as the explosive growth of smartphones continues, more customers (both remote and urban) will also use mobile applications.

In both developed markets and RGMs, the evolution of the branch experience will continue. Most customers prefer a self-service approach for basic transactions but expect personal contact for advice and complex solutions. Given the cost of branch infrastructure, more banks should be encouraging this division, and we are likely to see more transformation projects.

9. Technology
Banks are facing multiple stress points on their technology. End-of-life issues and years of under-investment are now being compounded by the multitude of new regulations already placing considerable stress on banks’ data and reporting platforms. Cybersecurity is also an ever-more prominent issue, particularly with outdated systems and data storage requirements that seem to grow exponentially.

Instead of incremental fixes and add-ons, a few banks have acknowledged that an enterprise-wide approach may be the only viable solution. Although the up-front investment will be significant, this will be outweighed by much improved efficiency and organizational effectiveness.
Last year’s Outlook said that technology will emerge as a key enabler and differentiator. As more system failures hit the headlines during 2012, that statement is perhaps even more relevant. We’re not sure how many more banks will be bold enough to commit to such a program, but more should be. The investment should also yield both direct and indirect revenue benefits. Better-suited systems will enable staff to deliver much improved customer service.

More directly, banks can learn a lot from other industries, retailers in particular, and have an in-built advantage as they collect far more data than single retail organizations. Using advanced data technology to track and analyze client activity will enable banks to provide much more targeted services and solutions to both retail and business customers.

10. Mobile money – finally a tipping point?
After a few false starts, we believe the combination of new platforms, customer expectations and industry innovation has finally brought us to a tipping point in the mobile money journey, both for banking and payments.

Most banks have already embraced the revolution to some degree. Some have been particularly enthusiastic, developing new products that leverage contactless payment technology and launching new mobile applications. Mobile banking is often at its most sophisticated in some of the RGMs, where a lack of physical branch infrastructure has been the catalyst for innovative mobile services.

However, not all of those first movers have been successful. With the exception of complaints management, mobile banking offerings continue to cause customer dissatisfaction. Ongoing security concerns, among both retail and business customers, will play a part in that. The laggards will need to move quickly to develop an offering that meets customer requirements, but they can learn from previous mistakes to improve functionality and delivery.

As more banks commit to the significant investment required, they will also need to persuade customers to use the new services. We should see more banks experiment with a “carrot and stick” approach to encourage a behavioral shift away from more expensive traditional channels.

Whether the challenge facing an organization is capitalizing on growth opportunities or mitigating the impact of contraction, taking a whole-business approach to reshaping the business will be critical. All of these key components are very much interconnected, and the change agenda needs to reflect that.

As customer sales and service delivery models evolve to leverage new technology, span geographies, use multiple channels and incorporate new regulations, the distinction between the historic front, middle and back offices will become increasingly blurred.

How banks redesign their operating model – the “engine” that supports the business – will need to reflect this shift, just as the business model is adapted to mirror the new external environment. Banks that adopt a wait-and-see approach and continue with incremental changes may be wasting this opportunity and are unlikely to meet the expectations of investors, customers or staff.

Some institutions are already embarking on bold strategies as the bank responds to its particular challenges. Over the next couple of years, we will see (hopefully) more follow suit and act with a sense of urgency.
The global economy – finally headed in the right direction?

As policy-makers on both sides of the Atlantic struggled to resolve multiple issues, it was central bankers who took the first decisive steps to restore confidence to the markets and the broader economy. They have also bought time for the politicians to agree on longer-term measures to resolve structural issues.
Finally, progress in Europe
As we head into 2013, the situation in Europe has improved. The long-term refinancing operations (LTROs) of the European Central Bank (ECB) have helped ensure there was plenty of liquidity in the system, but fears of a Eurozone break-up had frozen the transmission mechanism. The ECB’s commitment to preserve the euro and the launch of its Outright Monetary Transactions (OMT) program have eased fears and reduced borrowing costs for the Italian and Spanish governments.

The proposed banking union, when fully implemented, will give the ECB supervisory powers to intervene directly in any of the Eurozone’s 6,000+ banks. It will also enable funds from the European Stability Mechanism (ESM) to be used to recapitalize struggling institutions, breaking the destructive feedback loop between sovereigns and banks. A single deposit guarantee scheme has also been proposed, but disagreements over its structure may push any benefits from that into the distant future.

As a result of the OMT and the banking union proposals, banks in the Eurozone’s periphery are finding it slightly easier to raise funds on the open market and deposit levels are starting to rise again, at least at the stronger banks. Spreads between German and Spanish/Italian interest rates on loans have started to narrow, though only a little, and credit conditions are likely to remain tight.

Unfortunately, the benefits from these positive steps could be eroded, with disagreements over the construct of the banking union and whether the ESM can be used for legacy issues at banks in Ireland and Spain. Until these remaining uncertainties are addressed, and prospects improve in the peripheral economies, we’re likely to see continued challenges for banks and borrowers as GDP growth in Europe remains muted.

Cross-border lending between banks in the Eurozone will be restricted to the larger and stronger institutions, and funding costs will be higher for those in the periphery. Match-funding assets and liabilities in each market will also continue, as banks look to operate national balance sheets.

The US – better but not good
In the US the picture is more upbeat but still mixed. Growth in 2012 was positive but below long-term trends, and unemployment has remained stubbornly high. Spending and investment levels continued to fluctuate, and with no clear solution to the “fiscal cliff,” uncertainty crept back into the economy in the run-up to the presidential and Congressional elections.

This lack of confidence was highlighted during the round of third-quarter earnings calls, when several major US corporations sounded a note of caution. Rather than talk about growth, the focus was on faltering demand and potential job losses.

A further round of quantitative easing did provide a much-needed boost to the housing market. Recovery is slow, patchy and from a low base, but during the latter part of 2012, banks were reporting significant increases in mortgage applications. The majority of those were to refinance existing deals, but it’s a start. Businesses and consumers are also starting to borrow again, but credit growth continues to be stop-and-go.

In many respects the outlook for the US is binary. If President Obama and Congress work to avoid the fiscal cliff (or at least the worst effects of it) and establish a credible plan for deficit reduction, then we are likely to see an uptick in confidence, corporate investment and consumer spending. Failure to act could see the US tip into recession during 2013, with all the implications that brings for the world economy and the banking industry.

Rapid-growth markets – emerging from a slow-down
China seems to have succeeded in engineering a reasonably “soft landing” without resorting to the level of stimulus used in 2008 and 2009, and the new leadership will want to start on a positive note. However, concerns remain over the property market, loans to municipalities and the potential impact of further problems in the US and Europe on China’s recovery.

Time for bold action   Global banking outlook 2013-14
Bank reserve requirements were cut again during the course of the year to stimulate lending. In a more interesting development for the longer term, banks were also given more freedom to deviate from the People’s Bank of China benchmark interest rates for deposits and loans. The hope is that the relaxation of interest rate regulations will become a permanent feature of the Chinese banking system.

As growth recovers, demand for commodities and raw materials will boost a broader recovery amongst China’s trading partners in developed and rapid-growth economies. In markets that have seen a marked slowdown, such as Brazil where GDP growth has slowed from 7.5% in 2010 to a projected 1.5% in 2012, a bounce-back in 2013 will be a welcome relief for the economy and for banks worried about rising non-performing loan levels.

Throughout the rapid-growth economies, 2013-14 will see further significant investment in infrastructure (the Asian Development Bank predicts USD8 trillion over the next 10 years). As well as supporting growth and promoting greater domestic consumption, we’ll also see these economies develop higher-end industries to reduce dependence on the export of raw materials and commodities.

The key question is how that investment will be funded. As these economies become more stable and their sovereign debt is classified as “investment grade” status, international investors in search of higher yield will plug some of that gap. However, these markets also need to unlock their own domestic and regional funding potential. The considerable savings and wealth that already exists, particularly in parts of Southeast Asia, need to be redirected from investing on the international markets to local ones.

For that to happen, the debt capital markets in these economies need to make significant advances. The current momentum suggests that could happen over the next couple of years. Improved levels of corporate governance and a reduction in the size of the “unofficial economy” will also allow businesses to access the capital markets for funding and become less dependent on bank loans.

As table 1 shows, global growth is predicted to recover across most major developed and rapid-growth economies in 2013-14. The uncertainties already outlined could derail that, as could geopolitical shocks such as an escalation of tension in the Middle East causing a surge in oil prices. However, this outlook for the banking industry is based on the expectation (hope?) of some recovery.
### Table 1. Real GDP growth for the G20 group of countries 2011–14

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Source: Oxford Economics
Costs are rising and returns are falling as banks begin to apply the new standards on capital, liquidity and leverage. Business models remain under review and further strategic shifts are likely in the short-to-medium term.

External pressure is a key contributory factor. Most major banks have been forced by the markets to providing commentary on their compliance with Basel III capital standards. There is also an expectation that firms will already exceed those standards, several years ahead of the deadline.

The spate of regulatory and compliance issues during the course of 2012 has raised the prospect of yet more regulation. As some problems date back several years, regulators may give new rules time to work before supplementing them. In other cases, such as LIBOR, changes are inevitable and may be long overdue.

There is still much uncertainty that prevents banks from completing their change programs, but the costs and implications of the new regulatory environment are slowly becoming clearer. However, other challenges remain.

Which timetable; whose rules?

For banks that operate across borders, a major frustration is that national regulators are working to increasingly divergent timetables. As rules are finally published, it is also apparent that more regulators are putting their own twist on globally agreed standards. Banks will spend much of the next few years trying to navigate their way through the minefield of “home versus host” regulator conflicts, though recent US/UK proposals on resolution may help the G-SIFIs.

The preference that many jurisdictions now have for subsidiaries over branches will affect the cost and complexity of a global footprint, raising the prospect of trapped capital and ring-fenced systems. As a result, banks will also be trying to structure their business to mitigate the effects of regulatory nationalism.
For the major international banks, the complexities of dealing with multiple regulators are illustrated by the inconsistencies of structural change, recovery and resolution plans, and over-the-counter (OTC) derivatives reform.

**Structural reform**

The US and Europe continue to be the primary forces behind structural changes to the banking industry; authorities in Asia and Japan seem unlikely to opt for major new reforms.

Under the Volcker Rule, the US has focused on restricting proprietary trading and hedge fund/private equity investments anywhere in the group. Implementation was delayed following disagreement on the exact requirements, but it is now due to take effect early in 2013.

The EU’s Liikanen report, if adopted, could result in widespread reforms of the banking sector at both the national and European level. For banks with retail operations in the UK, there will be additional uncertainty as a result of inconsistencies between the Liikanen proposals and the UK’s Independent Commission on Banking (ICB) recommendations. The ICB puts the ring-fence around the retail activities, while Liikanen puts it around the trading operations.

These reforms have profound implications for how banks structure their global, regional and national operations going forward. The structural challenges are further complicated by developments on the recovery and resolution plan (RRP) and OTC derivatives fronts.

In response to these changes, various innovative operational structures are under consideration that could help banks meet the various national requirements (e.g., through the creation of operational subsidiaries) with greater flexibility. However, different approaches to structural reform may accelerate divergence in banks’
Reform

OTC derivatives reform

OTC derivatives reform, including central clearing and trading on exchange, is causing sweeping changes across the industry. In the short term, banks will be particularly focused on meeting Dodd-Frank deadlines for registration, reporting, client classification (onboarding and documentation), recording of conversations and data retention.

In Europe, technical standards are still being developed, and that slower pace will continue to cause its own problems. Foreign banks will continue to face challenges managing their relationships with US entities, in certain cases scaling back their dealings until there is more clarity about issues such as substituted compliance of home country rules for US standards.

The OTC reform agenda has both process implications as well as major, long-term, strategic impacts on banks’ business models. As rules become clear, banks will move beyond a tactical focus of responding to developments and take a more strategic approach to the management of their derivatives business on a global basis. Key questions to address over the coming months include the choice of counterparty, booking centers, product selection and where to clear OTC derivatives on a global basis.

Banks also will need to develop decision-making tools to achieve more efficient management of capital, liquidity and collateral across their global OTC derivatives activities and the manner in which they interface with central counterparties.

Recovery and resolution planning

In some countries, including the US, the UK and Switzerland, the largest banks have already submitted initial RRPs. These are being subjected to detailed reviews, but the assessment process will be iterative over the coming years. Other countries in continental Europe and Asia are moving on a slower path.

Across all of these markets, there will be significant implications for how banks structure their operations going forward. A key challenge will be the differing approaches that home and host supervisors take to cross-border coordination, should the need arise for a global bank resolution.

The US has established a presumptive path that would put the holding company in receivership, while maintaining the operating subsidiaries as going-concern entities. In other countries, that path is less clear. Indeed, the structural reforms previously discussed may complicate a global solution by ring-fencing critical operations locally without clarifying their requirements to support cross-border operations.

It will be important for banks to work closely with their home supervisors to achieve home-host cooperation and avoid pre-emptive ring-fencing behavior by host country jurisdictions.

operating models, leading to fragmentation within the industry, as well as level-playing-field concerns.
Time for bold action   Global banking outlook 2013–14
As the banking industry begins to emerge from global crises and more localized challenges, it is slowly moving through the different stages of response. Although some banks are still battling for survival, most are now focused on transforming their organizations to adapt to the new business and regulatory environment. A few, particularly in some of the rapid-growth economies, are in growth mode.

More organizations have emerged from the denial phase and have acknowledged the scale of the challenges ahead. Unfortunately, the market environment has slowed down the transformation process as banks, particularly those in Europe, have been unwilling or unable to accept write-downs on assets. As a result, there are still too many banks doing too many things. The anticipated return to growth in 2013–14 should help to accelerate the reshaping of the industry.

That process must also result in a sustainable business model that delivers an ROE that exceeds its cost. During this transformation, multiple business components will be in play, and the issues at the top of the agenda will switch over time. Some, such as the uncertain economic and regulatory landscape, are beyond direct control. All will require different responses depending on the bank and its operating environment.

Few components operate in isolation, and the successful banks will be those that consider them together and make bold decisions across the organization. The following issues, challenges and opportunities are what we believe will be the 10 key components for banks to consider.
A prolonged period of low interest rates across developed and emerging markets is forcing banks to adapt to lower levels of net interest income (NII).

2. Customers are increasingly willing to look beyond banks for banking services, and new providers are encouraging them:
   - Retail, technology and telecommunications firms are leveraging a mix of their footprint, expertise and customer base to expand their banking and payment services.
   - Major cash-rich internet firms are offering loans to business customers.
   - Shadow banks are broadening their reach into corporate and institutional customers.
   - At the other end of the scale, peer-to-peer lending is offering an alternative source of funding, particularly to small businesses.

The other components covered in this outlook will consider the implications and potential responses to these issues in more detail. However, the first question to consider is what space to occupy in the new environment. Given the challenges already outlined, the second question is: can that be done alone?

The profitability of middle-tier global banks is being squeezed by dominant leaders and smaller niche or regional players. Within their domestic markets, G-SIFIs will face pressure from the next tier of banks that aren’t subject to the same capital constraints or restrictions on acquisition. Some banks have already announced bold repositioning strategies in response to these challenges. More need to follow.

Asset sales, wind-downs and deleveraging will be a feature of the landscape for some time to come. The International Monetary Fund estimated in 2012 that European banks alone will shrink their balance sheets by more than USD2.5 trillion by the end of 2013. Risk-weighted assets (RWAs) as a percentage of total assets have continued to fall in Europe as well as North America (see chart 2).

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Chart 1. Average ROE among top 40 global banks 2009–12*

Source: Bank reports

*2012 for H2 results. Top 40 global banks by assets as defined by The Banker Global 1000, July 2012. Standard Chartered has replaced Credit Mutuel in this analysis due to the latter’s limited public reporting. 6M2012 figures exclude The Norinchukin Bank and Sumitomo Mitsui Financial Group due to reporting dates.
In addition to the cessation of certain activities, consolidation will also play a role across different markets. In some cases this will be encouraged by activist regulators targeting a certain number of banks, as in Vietnam. Investors will also pressure management in organizations where price/book ratios remain stubbornly below par.

As the remaining banks continue to transform their models and new entrants develop theirs, the next few years will be key to carving out a position in the landscape. Those exiting markets will need to find alternative coverage models to keep international customers; those arriving may be looking to partner on infrastructure.

There are lessons here for banking from other industries – think of how firms in the utilities, telecommunications and media sectors share infrastructure and, in some cases, content. We are likely to see more solutions emerge through non-traditional methods, with partners inside and outside the industry.

On the revenue side, some banks are already partnering with in-house asset management arms to fund the loan requirements of banking customers. Regulation permitting, this trend is likely to continue. Yield-hungry institutional investors will bear the risk as banks provide advice and credit expertise, collect fees for origination and distribution, but pass on the NII.

This intermediation role is not new, but it could expand significantly beyond large loans for multinational corporations. Partnering with peer-to-peer lending sites may be another option, as they expand and require additional expertise and infrastructure. The rise of retailers-as-banks will also provide options for banks to provide white-labeled services.

We should also see more sharing of infrastructure between banks. Across RGMs such as Indonesia and Turkey, there are multiple point-of-sale machines in retail outlets. In Brazil there is currently no shared database on customers’ credit histories. Although there is huge growth potential, costs are rising and competition is becoming more intense. As a result, we’re likely to see greater industry-wide cooperation to improve efficiency.

In developed economies as well, further efforts are likely to develop industry-wide solutions to common problems, such as cybersecurity.

The banking industry does not have a great track record with measured change, tending to veer from rapid growth to extreme cuts. In some cases, those responses make sense. However, given the ongoing uncertainties, the biggest challenge in adaptation may be retaining the ability to flex responses as unknown opportunities and risks emerge. A close second will be making sure that senior management devote enough time to the future and aren’t swamped by legacy issues.

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**Chart 2. Average RWAs as a percentage of total assets**

<table>
<thead>
<tr>
<th></th>
<th>2009</th>
<th>2010</th>
<th>2011</th>
<th>6M2012</th>
</tr>
</thead>
<tbody>
<tr>
<td>North America</td>
<td>12%</td>
<td>15%</td>
<td>18%</td>
<td>20%</td>
</tr>
<tr>
<td>Europe</td>
<td>18%</td>
<td>20%</td>
<td>22%</td>
<td>24%</td>
</tr>
<tr>
<td>Asia-Pacific</td>
<td>20%</td>
<td>23%</td>
<td>25%</td>
<td>27%</td>
</tr>
</tbody>
</table>

Source: Bank reports

* 2012 for H1 results. Top 40 global banks by assets as defined by The Banker Database, July 2012. Standard Chartered has replaced Credit Mutuel in this analysis due to the latter’s limited public reporting. 6M2012 figures exclude The Norinchuksin Bank and Suniloma Mitsui Financial Group due to reporting dates.
As the industry adapts to a new future, fixing its reputation will be a major part of that process. As Ernst & Young’s 2012 Global Consumer Banking Survey showed, there was a net decrease in confidence levels (see chart 3).

Perhaps not surprisingly, some of the biggest gaps were in Europe and North America, but the industry also suffered in Australia, Japan, South Korea and in some RGMs, including Chile and Vietnam. More recent challenges around mis-selling, LIBOR and anti-money laundering will only have exacerbated the situation.

Part of the problem is industry perception versus bank experience. The same survey found that the vast majority of customers are happy with their overall banking experience (87% either satisfied or very satisfied — see chart 4). However, few would disagree that the problem is one of substance and not just public relations.
The consumer protection agenda is strengthening, and the rise in consumer activism is unlikely to subside soon. On product suitability, the pendulum has swung from “buyer beware” to “bank must protect” and is unlikely to swing back toward a middle position in the short to medium term. Although the recently publicized mis-selling issues date back several years, there is also a danger of policy-makers demanding that the pendulum swings even further. Additional restrictions are not beyond the realms of possibility.

The problem extends beyond customers. Banks also need to restore their reputation with shareholders. Developing and delivering on a future strategy that is credible is a start. Implementing compensation models that encourage a longer-term view and recognize a lower-return environment will further improve shareholder relations as well as shareholder returns. That initiative will also begin to address the industry’s tarnished image in society.

In dealing with these issues, banks must shift their stance from reactive to proactive as part of the process of restoring confidence. There may be widespread understanding of the benefit to society of core banking services (e.g., current/checking accounts, loans and savings products), but there is a gap when it comes to many corporate and investment banking activities. Demonstrating the crucial role of the intermediary for businesses and institutional investors such as pension funds will help.

The reputation lens is going to be an ever-more prominent filter for banks as they adapt their organizations to the new environment. Some banks are already talking openly about restoring their reputation and taking steps to reduce the scope for future damage. Others should follow a similar approach as they review their business models and assess new product development options in the context of public perception and reputational risk.

Implicit in this restoration exercise will be refraining from activities that do not have a demonstrable benefit for customers. Regulatory restrictions on proprietary trading are already helping, but this issue goes beyond the investment bank. It will also be relevant as banks consider how to benefit from the vast quantities of customer data they collect. Using it to provide customers with more targeted products and services would be welcomed; selling it to third parties probably won’t be.

Governance models will remain under scrutiny. The Group of Thirty’s 2012 report, Toward Effective Governance of Financial Institutions, was developed in collaboration with Ernst & Young and Tapestry Networks and outlined a number of recommendations. Although it stressed there should not be a one-size-fits-all approach, some aspects, such as a combined Chairman and Chief Executive Officer role, will continue to come under pressure.

The reputation lens is going to be an ever-more prominent filter for banks as they adapt their organizations to the new environment.
Outlook

Three

Alignment – strategy, culture, behavior

Regardless of location or client base, the current environment is challenging for those working in banking. Some will thrive on it, but many will struggle with the scope and scale of the change agenda, even if it’s more about growth than survival. If efforts to restore the industry’s reputation are to be sustainable in the long term, they must be matched by a behavioral shift within the organization.

Boards and senior management recognize this need for change but are navigating a particularly complex set of circumstances. In addition to motivating staff suffering from project fatigue, they must remain focused on customer requirements and simultaneously implement restructuring initiatives to cut costs and personnel. There will be a danger of expending too much energy on legacy issues and too little on the future.

In those banks where the transformation is more akin to a turnaround, the leadership must also address the sensitive issue of whether the organization has the right skills to manage the change program and execute successfully. Failure to implement may be more of a risk to the business than an imperfect strategy.

The near-term risk of losing key staff has been mitigated by a depressed recruitment market offering few alternatives. However, banks in RGMs are already experiencing talent gaps in growth areas such as wealth management and key functions (risk, finance and IT). As those markets recover from their slowdown, some staff may be persuaded to relocate.

Resolving conflicts

The longer-term goal of making sure that staff behavior throughout the organization reflects the bank’s new strategy, culture and appetite for risk will be more challenging. Communicating that vision is part of the process, but much more is needed to cascade what that means for staff in practical terms. In some cases, that will be making sure staff understand that problems should be escalated and not buried; senior management will also need to convince staff that early reporting of issues is welcomed in reality as well as in theory. This will be particularly crucial where previous mixed messages have resulted in different parts of the business operating under different cultures.

Efforts to restore the industry’s reputation must be matched by a behavioral shift within the organization.

Chart 5. Top challenges to strengthening the risk culture

<table>
<thead>
<tr>
<th>Challenge</th>
<th>Percentage</th>
</tr>
</thead>
<tbody>
<tr>
<td>Systems and data</td>
<td>73%</td>
</tr>
<tr>
<td>Balance between sales-driven front office culture and risk-focused culture</td>
<td>63%</td>
</tr>
<tr>
<td>Enforcing accountability</td>
<td>43%</td>
</tr>
<tr>
<td>People are resistant to change</td>
<td>25%</td>
</tr>
<tr>
<td>Aligning group risk parameters with entities/countries</td>
<td>25%</td>
</tr>
</tbody>
</table>

Source: Progress in Financial Services Risk Management, IIF/Ernst & Young, 2012
As the IIF/Ernst & Young 2012 risk management survey, *Progress in Financial Services Risk Management*, showed, one of the biggest challenges around culture is resolving potential conflicts between the sales-driven front office culture and the risk culture (see chart 5). Banks will strive to address these issues during the early stages of implementation, and the more successful ones are likely to follow a multipronged approach to embedding new approaches.

Restructuring compensation models should be part of the process, as some banks are beginning to demonstrate. This will help to improve the industry’s reputation, as outlined. In addition, it will help ensure that incentive structures are aligned to desired behaviors across the organization, helping to overcome potentially competing demands.

A new approach to compensation is also unavoidable from a financial perspective – the high-risk, high-reward mantra is no longer viable for many organizations as their product mix changes. However, as with many other issues facing the industry, there may be a temptation to over-correct. Pre-crisis bonus levels may not be justified, but banks still need to protect their franchise and retain key staff. More organizations will aim to do that with structures that reward over the long term.

As banks in the RGMs continue to expand, the challenge for them will be to avoid diluting the original culture. Growing pains will be inevitable, but management will need to help ensure that new staff, particularly those that may have joined from overseas, adopt the organization’s behavioral norms. For those that are building out an international presence, we’re likely to see more employ exchange programs and secondments to mitigate the risks.

For some, the scale of the transformation required will resemble the turnaround of a business in distress.
Global business and consumer confidence remain weak. The ROMs have maintained reasonably robust activity levels, and we’re starting to see stronger growth in some developed markets, but customers remain wary of major spending and investment commitments. Major corporations are sitting on huge cash reserves, reluctant to deploy them, and in the Eurozone, total loans to businesses and households will return to 2011 levels only by the end of 2014.

As the Autumn 2012 edition of Ernst & Young’s Global Capital Confidence Barometer showed, over 65% of the senior executives surveyed said they expected the global economic downturn to persist for at least the next one to two years (see chart 6).

Chart 6. How long does your organization expect the global economic downturn to persist?

Source: Global Capital Confidence Barometer, Ernst & Young, October 2012

The changing customer
Subdued activity levels are unhelpful as banks think about how to serve current and future customers post-business transformation, masking the changing structural dynamics across the customer landscape:

» Service expectations are generally higher.
» Product demands are more varied.
» Customer loyalty is less assured.

Ernst & Young’s 2012 Global Consumer Banking Survey highlights this, with consumers becoming more multi-banked in all regions and more likely to switch their main banking relationship (see chart 7). In addition to price, key drivers behind this include the desire for a more personalized approach and more targeted products and services.

Online social networks are fast becoming a major source of information for consumers and a platform to share and comment on experiences, as well as to communicate with businesses. Digital banking is increasingly the norm for straightforward banking activities, and there has been an explosion of mobile applications to support and enhance that experience.

In response to this “digital revolution” and the competition from non-traditional providers, banks will need to show more innovation as they engage with customers via social networks, going beyond bland corporate feeds and sponsored advertisements.

Sales and service delivery models are currently being reviewed by a wide range of institutions. As that happens, organizations need to seize the opportunity to examine whether any proposed reorganization will actually improve interactions with customers and deliver a deeper understanding of their requirements. Shifting behavioral norms should extend beyond risk and regulation to how banks and their staff interact with customers.
Banks collect much more customer data than most other organizations and should embrace the “big data” revolution to use it. They will need to make sure insight from engagement via social networks is captured and acted upon, with more investment needed in customer data analytics. The laggards must also incorporate these behavioral changes into channel strategies and the functionality of their retail spaces, both physical and digital.

**Gaps in expectation and understanding**

At the corporate level, most major multinationals expect, and receive, a lot of attention from their core banks. Yet even with this client segment, banks can fall short in understanding their customer needs and providing innovative solutions. As they reshape their business and operating models, improving consistency of service delivery should be yet another factor to incorporate.

There is also a danger of banks taking a short-term approach to aspects of these relationships. As they restructure and focus on boosting capital levels, credit facilities will come under pressure. However, Ernst & Young’s Survey of multinational corporations* found that these multinationals expect their core banks to demonstrate a longer-term commitment to credit provision. For some institutions that are no longer able to meet that requirement, adapting to the new environment may also mean finding new customers. The key will be to identify and keep the right customers.

*Banks will need to show more innovation as they engage with customers.*
The economic downturn has led to changes in buying behavior, highlighted during the first half of 2012 when over 50% of new corporate funding was raised via the capital markets instead of bank lending. Whether that is a cyclical event driven by low bond yields or a more structural shift is unclear, but it is yet another factor to consider.

Many investors are still waiting for a compelling proposition. As organizations tread a fine line to please different stakeholders, the challenge — as chart 9 illustrates — is to deliver a reasonable return with an acceptable risk profile.

Withdrawing from certain activities, even for a limited period, may cause long-term damage to relationships as well as provide opportunities for competitors. As the customer discussion highlights, banks will be expected to deliver innovative, full-service solutions, not limited services. Game theory may become a reality over the next couple of years while banks make difficult choices.

For different reasons, banks across markets are facing margin compression across their product range. Regulation, funding costs, lackluster demand, low interest rates, price competition and shifting buying patterns are all affecting profitability. The pessimistic view among the banks’ corporate customers is highlighted by their attitude to M&A (see chart 8).

The product conundrum
The dilemma for many, particularly in developed economies, is which business lines, products and services to cut without causing irreparable damage to future revenue opportunities when growth returns. Efforts to shrink balance sheets, or at least reduce risk-weighted assets, are being hampered by a reluctance or inability to accept write-downs or losses. European banks are still finding it hard to access sufficient quantities of US dollar funding. Elsewhere, banks are finding their business activities constrained by local regulations exceeding global standards.

Chart 8. Do you expect your company to pursue acquisitions in the next 12 months (percentage of positive responses)?

Source: Global Capital Confidence Barometer, Ernst & Young, October 2012
Although not ideal, agreements or partnerships with third parties may be one solution to maintaining full-service capabilities. These might be with other banks to deliver coverage or, as discussed earlier, with institutional investors in search of better returns. Some organizations will also continue to hedge their bets and accept short-term losses in the hope of profitable growth later on.

Finally, the scalpel appears

Capital considerations may ultimately determine decisions, particularly for those trying to raise it in the short term. We will see much greater contraction in global capabilities over the next couple of years as firms accept the inevitable and modify their ambitions.

Given this, and the evolving expectations of customers, the next one to two years will also be about reviewing key client lists and revising customer acquisition/retention targets to align with the new reality.

In some product areas such as equities and fixed income trading, scale is king. The investment required to deliver further trading automation will prove prohibitive for most, and the top-tier banks will benefit from the retreat of mid-tier organizations. The cuts will also have secondary effects for the research and analysis functions at these banks.

In other business, such as M&A advisory, size and systems are less important and smaller specialist houses will continue to find a niche. Their size may also benefit them as they’re less likely to face issues with potential conflicts of interest.

New, alternative providers are also emerging in the small and medium enterprise (SME) loan space. Peer-to-peer (P2P) lending will continue to grow, though from a low base (P2P in the UK reached GBP250 million in June 2012, still a fraction of the overall market). We also expect to see more cash-rich large corporations using their balance sheets to provide SMEs with loans to buy their products and services and to support smaller companies in their supply chain.

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**Chart 9. The strategic dilemma: balancing risk and return**

Source: Getting Risk Governance Right, Thomas Huertas, Ernst & Young, 2012.
New markets, new banks

Banks with the most severe capital constraints will continue to exit or reduce exposure to sectors like commercial real estate and project finance. Transaction banking remains seen as a strong opportunity by many, but this is not straightforward. Many clients will expect banks to provide the trade finance element of transaction banking as well as the low-capital aspects, such as cash management. A limited service offering may not be viable, and we are already seeing shifts in trade finance activity away from some traditional European banks toward Japanese and regional RGM institutions.

Indeed, increased trade flows to and between these emerging markets, as well as the projected rise in infrastructure spending over the next 10 years, will present significant growth opportunities for banks that have a credible footprint in these countries. Many of the larger emerging market banks are already running a universal model, and we can expect further build-out of their capabilities and their footprints in the next couple of years to exploit these opportunities. They will also benefit from relatively strong capital positions.

As an example, international bond issuance in Asia (excluding Japan) is growing rapidly. Although still small by global standards, it has risen to USD106 billion in the first nine months of 2012 from an annual total of less than USD20 billion a decade ago. The Association of South East Asian Nations (ASEAN) is expected to have its economic community operational during 2015, which should further improve capital and trade flows within the region.

In markets such as Indonesia and Turkey, credit is growing at over 20% per annum, and the current levels of under-penetration will result in significant growth over the next couple of years. As well as in conventional products, we’ll see much more investment in Islamic banking capabilities. However, not all RGMs present such strong opportunities. In Malaysia, the market is still growing, but price competition among well-established banks will threaten profitability.

Competition in premium banking will also intensify as more banks woo affluent customers. Wealth management will emerge as a much stronger opportunity, particularly as political stability encourages high net worth individuals to keep their assets onshore. However, the cost to serve these clients can be high, and margins will be squeezed as international banks compete with local ones for clients and talent.

Another threat to margin in these markets is a sustained period of low interest rates, where a mix of competition and political pressure is leading to lower borrowing rates and lower NII. Volume growth will help to offset this, but banks will also be reducing their dependence on this income stream by introducing more fee-based products and services. Efficiency will be much higher on the agenda, as will risk management to minimize default rates and credit losses.

Declining NII also remains a feature in some developed markets. Consumer demand for mortgages may be increasing in the US, but low rates are squeezing margins. The fixed-rate products will have a longer-term impact on revenues.

Efficiency will be much higher on the agenda, as will risk management to minimize default rates and credit losses.
Pricing – old challenges, new models

Banks are concerned about profitability. Customers are complaining about prices. It’s difficult to think of a time when both of those statements haven’t been true but the confluence of multiple factors has placed pricing firmly on today’s agenda.

There are a number of drivers behind this, all of which will influence the pricing discussion in the coming months:

- Cost of funding – whether via customer deposits or the markets, many banks are having to pay more for funds to lend
- Capital charges – the additional capital charges imposed under Basel III for loans and other products will overturn the assumptions in many pricing models
- Customer expectations – business and retail customers are united in their desire to see more transparent pricing from banks and regulators are scrutinizing fees and charging schedules
- Consumer loyalty – loyalty is much less assured now, challenging retention and cross-selling assumptions

The first tranche of three-year funding under the ECB’s LTRO is due for repayment in December 2014. The stronger banks will aim for early repayment but the more vulnerable ones may struggle and we’re likely to see a period of intense activity, as well as some uncertainty, ahead of this deadline.

The funding challenge in Europe is exacerbated by the continued existence of too many banks chasing too few deposits. Although in retreat, loan-to-deposit ratios across the region are over 105% and much higher than that in some markets. In Spain, it is over 180%. The situation is easing in the peripheral Eurozone economies thanks to the recent policy announcements, but that is unlikely to reduce the cost of borrowing in these markets in the short term, particularly for SME customers.

Although the larger corporate clients tend to have a much stronger negotiating position, they also appreciate the implications of Basel III and view the relationship with their core banks as a partnership. As banks engage in potentially difficult conversations with these clients on the cost of capital, global pricing models should be one topic for discussion. Fees are generally transparent yet inconsistent pricing across geographies frustrates clients; addressing this could be part of a broader solution.

Pricing for retail customers is complicated by the presumption of “free” banking for basic current/checking account services across many developed markets. This distortion does not help resolve issues of transparency or perceived fairness but it will be difficult to end. Shifting the mindset of politicians, regulators and the public to accept a more transparent approach should be an objective but will take longer than the timeframe of this Outlook.

This contrasts quite starkly with the approach in many RGMs where pricing will continue to be based around transaction charges. Pressure is growing on credit card annual fees but at least there are alternatives compared to many developed markets. New services, such as mobile banking, may be free initially to secure customer adoption, but charges are likely to follow in these areas as well.

Irrespective of the exact pricing model, consumers across all markets are unhappy with the current approach. They are also frustrated that multi-product loyalty is not rewarded in meaningful ways. The most popular recommendation in Ernst & Young’s 2012 Global Consumer Banking Survey was that banks should implement changes to fees and charging structures.

Any assumptions of “one size fits all” have been outdated for some time and the analysis shows that banks need to act fast to provide pricing models that are innovative and more customized.

Many existing models are still dependent on cross-selling assumptions; with more customers becoming multi-banked, those models will cease to add up. As competition between banks intensifies across markets, as customers become less loyal and as alternative providers enter the market, there is a clear opportunity for differentiation.

Might one organization step up to offer a game-changing “new deal?” Will that be a bank, a retailer or a technology firm? Might smaller banks, perhaps mutuals or co-operatives, be agile enough to turn size to their advantage? Although many are struggling to overcome the cost burden of new regulation, offering an approach that is innovative and flexible may begin to compensate for that disadvantage.
Outsourcing and off-shoring have become well-trodden paths for many industries looking to improve efficiency, banking included. Although this is likely to continue in the short to medium term, banks are becoming increasingly concerned about concentration risk in some off-shore locations. Add to that the pressure from supervisors to improve control and oversight, and the scope to off-shore or outsource further may be reaching its limit for some. Instead, we’re likely to see more innovation around in-house provision and using lower-cost onshore locations.

In addition to dismantling historic silos, there will also be an opportunity for banks to learn from other sectors and further industrialize processes across the organization. We may also see some creativity around white-labeling and the further sharing of middle or back-office infrastructure. There is particular scope for this in some RGMs, where the sharing of ATMs and point-of-sale infrastructure is still limited.

Customer versus bank

There is also the other side of the equation to consider – is the structure designed for the benefit of the bank or its customers? Teams providing credit cards, mortgages, consumer loans and current/checking accounts are often housed in different divisions of the bank. On the corporate side, treasury and cash management is often separate from lending and advisory.

From a client perspective – retail or business – this doesn’t make sense. For the banks, this sort of structure raises questions about duplication, overlapping responsibilities and
potential oversights. There are very few positives to take from the current challenges facing the banking industry. The opportunity to redesign structures to align with customers is one that relatively few banks have already seized.

As strategic discussions proceed, we expect more banks to incorporate these considerations and reorganize themselves to better reflect not only new realities but also what their customers are looking for. Given the stubbornly high cost/income ratios, particularly for North American and European banks, banks will also use this redesign phase to overcome the organizational politics that often prevents cross-selling (see chart 10).

How much is enough?

Some restructuring has been incremental rather than big-bang. As a result, stubbornly high cost/income ratios have revealed an institutional cost base that may be too heavy for the new organization. Over the coming months, we will see more banks switch gear and opt for big-bang.

**Is the structure designed for the benefit of the bank or its customers?**
With a few blips, the RGMs continue to live up to their name. As we saw on page 13, they are forecast to return to stronger growth in 2013 and 2014, just as many developed economies struggle to deliver historic averages.

The level of foreign direct investment (FDI) into these markets is expected to accelerate over the next couple of years as more investors focus attention on them at the expense of some developed markets (see charts 11 and 12).

The interesting shift is that the source of FDI will increasingly be other RGMs, and that trend is being replicated by trade flows between them. Developed economies will continue as a major export destination for years to come, but the dynamics are shifting as rising disposable income levels support greater consumption within the RGMs.

The global footprint

The banking landscape will continue to reflect these shifts. Banks in several European markets are under pressure to focus on core services in core markets and are either unwilling or unable to continue investment in RGMs. In some cases, their forays did not deliver expected returns but, given domestic pressures, must be written off as a sunk cost. Instead, those with stronger balance sheets and higher capital levels will continue their moves to support major infrastructure programs and businesses expanding abroad.

In some cases this will be North American, Japanese and Australian banks, particularly where that global expertise is highly valued by local businesses. We will also see further international expansion by Chinese and other RGM banks as they follow their corporate customers into new markets. However, how they expand may become more of a challenge.

More jurisdictions are expecting new entrants to establish locally capitalized subsidiaries instead of branches. In some cases those subsidiaries need to have independently controlled technology and systems infrastructure as well. The additional cost and complexity will not halt expansion plans, but they will make them much more selective. Although the future potential is significant, foreign banks trying to operate in China and India are also likely to face major restrictions for the foreseeable future.

Chart 11. FDI inflows to China and next five RGMs (based on 2014 forecast inflows)

FDI inflows in USD billions

Source: Oxford Economic
Those international banks that are unable to continue independent expansion into new markets will face a stark choice as they review their strategy – refocus their customer ambitions away from global multinational customers or find alternative ways of supporting that client base. Partnering with local or regional banks may be one option, although client appetite for using third parties may be limited.

The domestic footprint

According to World Bank data, France had more than 43 bank branches per 100,000 adults at the end of 2010, Mexico had 15 and Indonesia had 8. In the latter two countries the number is growing, and that is a trend we will see replicated across RGMs. In many of these markets, a physical presence is still expected and needed, particularly where internet access is still limited or where broadband infrastructure does not yet support mass online banking.

Branch networks will see significant expansion in large population centers, although elsewhere they may not always be physical “bricks-and-mortar” branches. More banks will be partnering with retailers or post offices. They will leverage new ATM technology to provide “automatic” branches. As the explosive growth of smartphones continues, more customers (both remote and urban) will also use mobile applications.

Even in developed markets, the death of branches is somewhat exaggerated. Consumers now prefer a self-service approach for simple banking transactions, but branches will remain important for advice and more complex banking decisions. Instead, we will see further evolution of the branch experience from something that looks like a local government office to a space that resembles a hybrid between coffee shop and technology store. This will give customers what they’re asking for; it will also improve returns on expensive infrastructure.

Chart 12. FDI inflows to the G7 group of countries (ranked on 2014 forecast inflows)

FDI inflows in USD billions

Source: Oxford Economic

Time for bold action   Global banking outlook 2013-14
How well banks respond by building more flexible data management frameworks to implement new reforms, while also containing overall costs, will have profound implications for their competitive position in the marketplace.

Instead of incremental fixes and add-ons, banks are realizing that an enterprise-wide approach may be the only viable solution. In many cases, the situation is being compounded by end-of-life issues and years of under-investment. The up-front investment will be significant, and technology spend will continue to increase across the industry for some time to come (see chart 13).

Inevitable cost

The multitude of new regulations is already placing considerable stress on banks’ data and reporting platforms. The Basel Committee’s recent guidance on data aggregation and reporting will require banks to fundamentally upgrade their capabilities in this area by early 2016 (with supervisory assessments of compliance beginning in 2013).

Instead of incremental fixes and add-ons, banks are realizing that an enterprise-wide approach may be the only viable solution.
Making sure that new technology is flexible enough to support more sophisticated requests from customer teams and regulators will benefit the bank and its customers. Firms will clearly need to be sensitive to privacy concerns, but Ernst & Young’s 2012 Global Consumer Banking Survey illustrated that most are willing to share more information if it will lead to a better service and more targeted offers.

The combination of lots of data and increasingly interconnected systems has brought the risks associated with cybersecurity to the fore. The frequency of attacks is accelerating, and although most are thwarted, the perpetrators are becoming more sophisticated. The prevalence of multiple devices accessing systems also multiplies the risk of a virus breaking through the firewalls.

As discussions at a recent meeting of the Ernst & Young and Tapestry Bank Governance Leadership Network highlighted, this is an industry-wide problem and one that demands cooperation. A rapid response to new threats will often be the difference between success and failure, and regulators should play a prominent role in facilitating a combined approach.

The option for industry-wide cooperation may extend beyond cybersecurity. As banks consider their options, a key question will be whether a customized solution is needed for everything, or whether partnerships with other banks and external vendors may be the optimal approach for aspects of new technology and data solutions.

Potential benefits

However, improving system resilience and eradicating technology silos will improve organizational effectiveness and service to customers. Those banks that standardize systems across multiple global locations should also generate significant cost savings over time. As firms go through restructuring, an additional benefit may be an improvement to the institutional memory. Information will be more easily accessible, and fewer manual “workarounds” should reduce the scope for human error.

As banks consider the investment, potential revenue opportunities should be factored into the decision. Other industries, retailers in particular, have a strong track record of using customer analytics to interrogate data and provide more targeted offerings.

We expect to see more banks follow this path and, as the 2012 Outlook highlighted, treat technology as both an enabler and a differentiator. Given more demanding customer requirements and expectations, banks will struggle to deliver improved service levels and pay for them through better cross-selling, without front-to-back technology changes.

Banks can learn a lot from other industries.
Mobile money in its various forms – banking, payments and peer-to-peer transfers – has been evolving for several years. Yet the rate of change, development and adoption does seem to have accelerated recently, with the smartphone serving as a key catalyst. (See projected growth rates in chart 14.)

The levels of attention and investment by banks so far have varied considerably. Some of the most significant advances have come in the RGMs, where mobile technology and innovation were initially used to reach new customers without building branches. Now, the range of services available via mobile application may include chatting live with the bank and organizing loans.

By contrast, bank customers in some developed markets will be lucky if they can view their account balance and make basic payments. If we have reached a tipping point in the mobile money journey – and we think we have – then how banks respond over the next couple of years will be critical.

A “VHS or Betamax” moment
Not everyone can be the first mover in this, and many banks don’t want to be. Particularly in relation to mobile payments, new start-ups are emerging almost daily, and there are multiple technologies still competing for primacy. A few banks will continue to forge ahead, either alone or in partnership with other organizations, but many will play it safe until there is greater customer adoption and some consensus around the technology.

However, as more alternative providers emerge and grow, transaction fees will be at risk. Whether it’s the start-ups offering better terms to merchants or digital wallets reducing customer use of credit and debit cards, banks will need to act to defend existing revenue streams.

We should see more banks experiment with a “carrot and stick” approach to encourage a behavioral shift.

Chart 14. Smartphone shipments by region, 2011-16
Total units in millions
For mobile banking, there should be a greater sense of urgency. Both retail and business customers still have security concerns, but as these are addressed and as customers use smart devices for an increasing number of non-banking activities, more will expect more from their banks.

The results of Ernst & Young’s 2012 Global Consumer Banking Survey dispel some common misconceptions about retail customers. It’s no surprise that younger segments are keen on mobile banking and older customers are more worried about security. However, even if security issues are addressed, older customers are still less likely to use mobile money applications because they’re perceived to be difficult to use. There’s also little difference in appetite between income levels.

For banks planning investment over the next few years, there is an opportunity to reach the under-served segments of the mobile customer base. They can also learn from the mistakes of others. With the exception of complaints management, mobile banking had the lowest satisfaction scores in the survey, so there’s definitely scope to improve the service offering.

New mobile platforms will be expensive and may not generate significant additional revenue, so cost efficiency will become a key factor. We should see more banks experiment with a “carrot and stick” approach to encourage a behavioral shift away from more expensive traditional channels. They could also explore how to translate some of the consumer-focused applications into new solutions for business customers, both SMEs and major corporations.

As smartphone usage explodes in the RGMs, one thing that may constrain customer and business adoption of mobile money services is poor internet connections. Banks will need to make sure that government and private sector investment in broadband infrastructure is sufficient to justify their own spending on new platforms and applications.

A few banks will forge ahead but many will play it safe.
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