

# Defining the new core of a bank

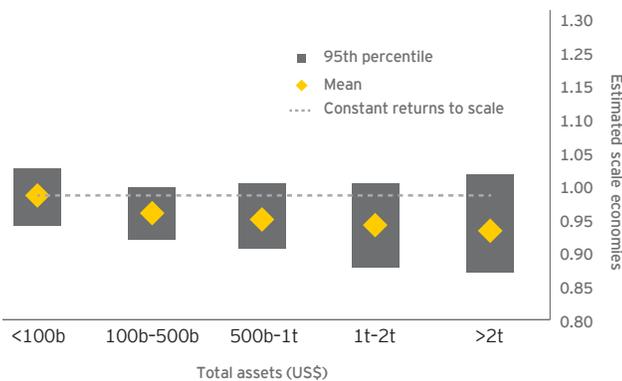
**W**hat is a bank? Fundamentally, it is an organization that takes deposits, lends and helps customers manage risks. Although this seems simple, over the past decade and more, a mix of consolidation and competition in global banking has created complex organizations, with diverse portfolios of products, operating across multiple business lines. The time has come for banks to simplify.

There is significant evidence of diseconomies of scope and scale within large universal banks (Figure 1), and we believe that a combination of the new regulatory agenda, changing customer behavior and a drive for operational efficiency within banks will force them to refocus on their core strengths. This means they will need to scale back areas of the business that do not create value or provide a competitive advantage. Some may exit business lines or turn to outside providers for particular services. As banks seek to rationalize their scope, we believe the next decade will be marked by the simplification of businesses, deconstruction of products and an end to the age of global universal banking.

## Simplifying businesses

In the immediate aftermath of the global financial crisis, there was a chorus of bankers reaffirming their commitment to global universal banking because it helped smooth revenue volatility. A host of regulation, from structural reform to tougher capital and leverage ratios, has changed that. EY analysis shows that genuinely global banks reported average ROEs of around 7.5% in 2013 while large banks with a less diverse business and geographic footprint were able to achieve an average ROE of around 10.7%.

Figure 1: Economies of scale (implicit subsidy-adjusted)



Source: Capital IQ, Bank of England calculations

Investor sentiment will force further change. If banks are going to report single-digit returns, investors want them to be low risk. If banks are going to take on risk, investors want higher returns. And finally, banks themselves are beginning to recognize the diseconomies of scope that come with universal models, the costs involved in being a flow monster, and the challenges of culture and governance associated with having an investment bank and a retail bank under one roof.

We have already seen some banks beginning to move away from the universal banking model and shrinking their investment banking divisions. Over the coming decade, we expect more banks to shrink in scope, focusing on highly profitable core businesses. Banks need to examine what is core to their business and where they create genuine value. We believe more banks will establish minimum hurdle rates of return for divisions. Parts of the business that don't create value – be it distribution channels, product manufacturing or core banking systems – will have to be improved. If they cannot be improved, banks must consider whether they are non-core and whether it would be better if they were provided to customers via an alternative supplier.

We also expect to see partnerships between domestic and international banks in emerging markets, where local institutions want to support their corporate and commercial clients as they expand overseas but lack the capabilities and capacity to do so. In return, these local banks will provide a distribution channel and fee-based revenue stream for more global institutions with broader capabilities.

As well as reassessing business lines, we anticipate banks reassessing their internal operations. Historically, banks have been poor at controlling the growth of their corporate center. Banks need to ensure that they actively control the cost of core operations. Despite the current focus on lean operations, there is a risk that when revenue growth returns, the corporate center will expand again. To help avoid this, banks should ask themselves whether a particular back-office function offers them a competitive advantage. If not, where regulatory and data-protection requirements don't prevent it, there is no reason for these functions not to be outsourced to IT and operations specialists. In some instances, this might be through a managed service arrangement but, in others, it is possible the majority of a bank's IT and data management could be handled by a cloud-based service provider or an industry utility. Procurement and supplier management will become even more important. In the most extreme circumstances, we believe some banks with advanced systems might even offer their core banking platform or other technologies or services from support functions as a service to other financial institutions not in direct competition with them.

## Deconstructing products

There is, in our experience, little correlation between the size and breadth of a bank's product set and its market share. Furthermore, there is little evidence that product proliferation has improved choice for customers. Instead, they have been left bewildered by an array of products with a variety of terms and conditions, few of which are suited to them individually. Although many banks have started talking about a customer-centric (rather than product-centric) approach, few have achieved it.

The product-centric approach has done little to benefit banks. They have had to grapple with the costs of managing and distributing all those products and increased conduct risks; the complexity and diversity of products has contributed to recent mis-selling to both business and retail customers. This has eroded trust in institutions while the concomitant fines have had a direct impact on bank profits – for example, US banks have been fined around US\$90b for mortgage and asset-backed security

mis-selling while payment protection insurance and interest rate swap mis-selling has cost UK institutions an estimated US\$40b in fines and litigation.

Global regulators are increasingly focused on customer protection and product suitability. The challenge for banks is to ensure their products are suitable when regulators are unwilling to approve individual products up front, but willing to penalize banks retrospectively. If banks are not confident of certain products' suitability, they risk further mis-selling scandals in the future. This is particularly true as banks look to develop new products to meet the developing needs of customers (see ["The quest for growth"](#)). It is compounded at institutions where banks have vast product sets that sales teams are unable to understand in detail. This means staff are more likely to make mistakes when advising customers, thus increasing conduct risk.

We believe that for banks to be truly customer-centric and to avoid the risks of mis-selling, products must become customer-driven. A customer-driven approach is already seen in other industries, where customers are becoming used to more personalized products and experiences. This has set customer expectations, and banks must adapt to match them.

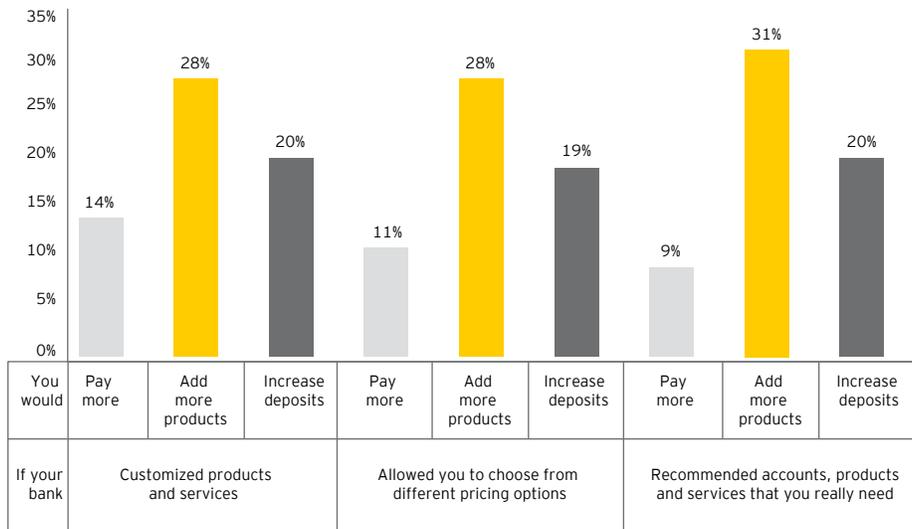
A move to a customer-driven approach will require banks to rationalize and simplify their product sets. By breaking products into their component parts, banks will enable customers to tailor-make products to suit their needs. Banks that achieve this will be able to provide customers with truly differentiated offerings. EY's *Global Consumer Banking Survey 2014* suggests

that banks that can achieve it will be able to win an increased share of wallet (Figure 2). They will also be able to reduce the cost of their operations and better satisfy regulators that they are treating customers fairly. However, achieving it will require reform of banks' internal systems, processes, operations and culture. Banks currently tend to view each variant of a product as a separate product – for example, mortgage accounts with different interest rates would be treated as separate products from a system perspective and would have individual manufacturing, marketing and distribution processes associated with them. Banks will need to change the way they view products – so they become simple "base-products" but have dynamic attributes (such as interest rates or fees) associated with them.

Just as importantly, banks will also need to develop a clearer understanding of the value of a product across its life cycle to ensure that these customer-driven, dynamic products are priced appropriately. This may be the biggest challenge for most banks. Typically, many institutions have a poor understanding of the full profitability of products, exacerbated by ineffective cross-charging models, complex business structures and poor data analytics. However, a combination of simpler businesses and rationalized product sets should give these institutions a better understanding of profitability, enabling them to completely transform their customer offerings.

We believe that as banks respond to consumer, regulatory and investor pressures to simplify, it will become more critical that they understand where value is created in their organizations.

Figure 2: A customer-driven approach can increase share of wallet



Source: EY *Global Consumer Banking Survey 2014*



Over the coming months, our *Transforming banking* series will explore why customers are increasingly attracted to new intermediaries, where we see leading practice among these institutions, and the investments that banks should make to compete with them effectively.

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