

Banking Transformation

Seismic changes are causing waves of opportunity

Views from the European retail banking industry

Introduction	1
Executive summary	2
Contacts	5

Introduction

European retail banks are facing continued macroeconomic, regulatory and reputational challenges.

Three years after the financial crisis emerged, it shows little sign of abating. Problems in the Eurozone continue to cast a dark shadow over the sector. Banks with large exposure to sovereign debt in troubled European economies face the prospect of significant write-downs, the need for further capitalization and the prospect of further losses on non-performing loans. Investor confidence in the banking sector has plummeted. The MSCI Europe Banks Index, which tracks the performance of European companies involved in the banking sector, has fallen significantly over the past year.

New regulation created in response to the financial crisis will intensify the pressure on retail banks. Higher capital and liquidity requirements and tighter wholesale funding markets, combined with recovery and resolution planning regimes

could reduce lending capacity and the profitability of banks. Those deemed to be systemically important financial institutions (SIFIs) will face especially strict capital and liquidity requirements.

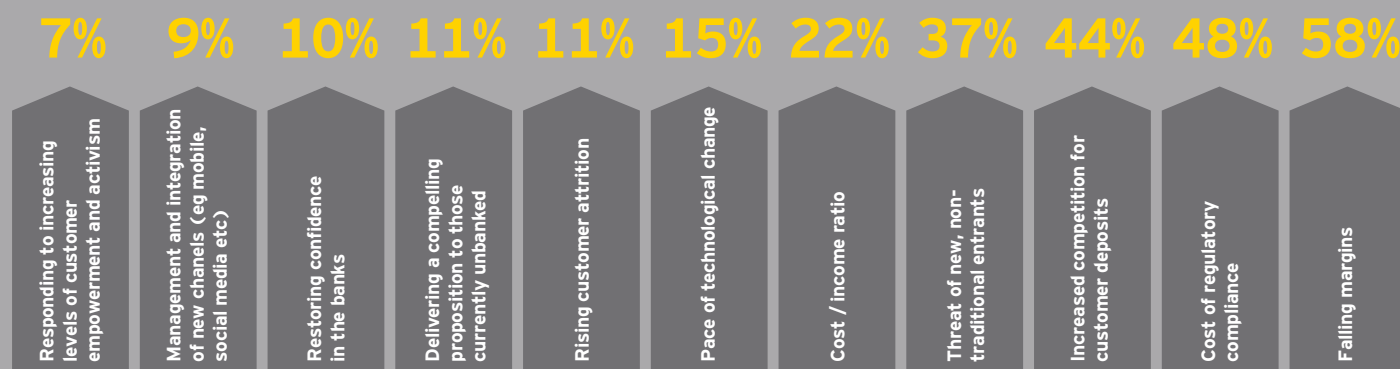
The relationship between retail banks and their customers also remains at a low ebb. Many institutions are struggling to rebuild reputations that have been severely damaged by the financial crisis. New consumer protection rules and financial stability regimes in some European markets could help to give customers greater confidence, but they will also increase the cost and complexity of serving them.

Against this highly challenging backdrop, the banks that succeed will be those that can differentiate themselves by offering a truly customer-centric service or moving

to a high efficiency business model. This will require a combination of service innovation across multiple channels and a relentless focus on increasing the efficiency of internal processes and the customer orientation and productivity of the workforce. This will be no small feat, but it will be essential if retail banks are to generate adequate returns in a heavily regulated and lower growth world.

In order to better understand banks' main concerns and how they are evolving in this environment, the Economist Intelligence Unit, on behalf of Ernst & Young, globally surveyed 654 bankers of whom 298 were senior executives at retail banks in the UK, France, Germany, Italy, Spain, Switzerland and the Netherlands. The respondents included chief executives, CFOs, CROs, COOs and heads of business.

What do you see as the key challenges facing retail banking over the next five years?



Source: EIU and Ernst & Young European retail banking survey 2011

Executive summary

The key challenges facing retail banking over the next five years, according to survey respondents, are falling margins, the cost of regulatory compliance and increased competition. This potent combination is likely to drive down returns on equity and make it increasingly difficult for retail banks to return to the performance levels seen prior to the financial crisis.

There is no question that retail banks face considerable pressure. Poor economic prospects will ensure that consumer confidence remains low for the foreseeable future. With wholesale funding markets remaining subdued, demand for retail deposits will increase, putting even more pressure on margins. Deleveraging among consumers and SMEs continues to reduce asset volumes, while a shift away from complex investment products towards more straightforward products and the regulators' desire for transparent charging are causing a decline in fees.

Banks must find ways to stem rising rates of attrition.

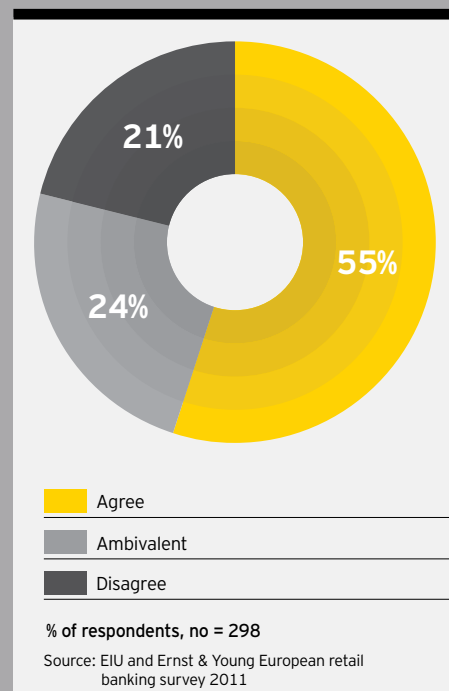
Almost six out of ten respondents say that levels of customer attrition have increased since the financial crisis. The rates can be high, with one in four banks experiencing customer attrition rates of 10% or greater, although this proportion is even higher among respondents from France (45%), Spain (38%) and Switzerland (40%). New regulation to make it easier for customers to switch accounts in some markets adds to the challenge for banks.

The costs of dormancy and attracting new customers are considerably higher than those that are incurred to retain them. With the added cost of opportunity lost from upselling and cross-selling, the survey highlights the importance of retail banks understanding the drivers of high attrition rates and stemming further increases. Our respondents say that high fees and complex charging structures are the key causes for customers to leave, although a poor branch experience, processing errors and a lack of personalized service also figure highly. Banks should respond by increasing transparency over fee structures, ensuring that products and services are tailored to different segments and redoubling efforts to make service more personalized and efficient. Customer analytics and end to end process transformation can play a powerful role in helping banks to develop a more complete picture of customer behavior that can then be applied to serve customers better.

The majority of banks are investing in improvements to customer service.

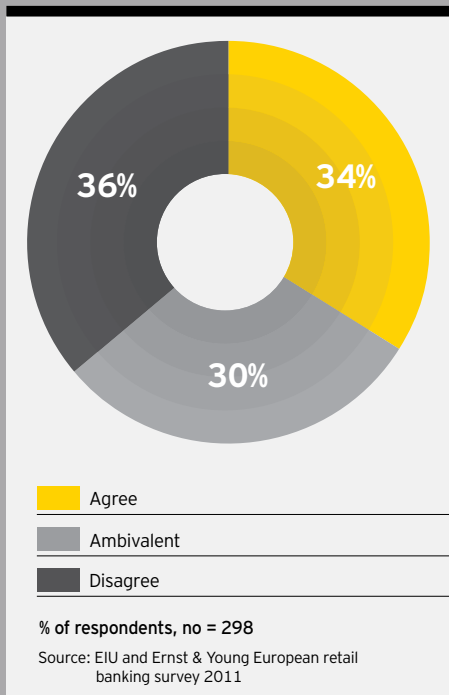
Although the vast majority of respondents think that their institution is already customer-centric, banks also recognize the need to invest in customer service. More than half of respondents say that they are planning significant investments to improve the customer experience. These levels of investment can be substantial: almost half of respondents say that they will invest more than US\$100m to transform customer processes in the near future.

We are planning significant investment to improve the customer experience within retail banking



Initiatives to simplify the banking process for customers are high on the priority list for banks in the survey. Asked where they thought improvements were most needed, respondents point to changes in fee structures, account switching and the opening or closing of current accounts. More than half intend to focus on improved employee training, while 40% intend to focus on straight-through processing. Banks hope that these initiatives will help to reduce processing errors and lower the cost of serving their customer base. Interestingly, however, only a third of respondents saw this improved customer experience as a way to enhance market positioning and attract new customers, suggesting that investment in customer service is being viewed as “mandatory” spend.

Within the next five years online and telephone based sales will overtake branch and face to face



Automation will become increasingly important.

At a time when banks are concerned about rising costs and declining customer loyalty, increased automation offers a rare opportunity both to improve customer service and reduce costs. Just over 60% of respondents expect that, where possible, all processes will be fully automated within five years. Technology can also be a service differentiator: almost three-quarters think that the internet and mobile services are key factors in attracting and serving new customers.

Branches will remain a key component of the customer proposition.

At the height of the internet boom, there was a growing consensus that technology would render the bank branch obsolete. Yet, as our survey demonstrates, rumors of the branch's demise have been greatly exaggerated. More than half of respondents agree that the majority of complex transactions are conducted through the branch network, and only 28% of respondents think that the number of branches they operate will be lower in five years' time. Just one-third of respondents think that online and telephone-based sales will overtake branch and face-to-face levels within the next five years.

If anything, the role of the branch is becoming even more important at a time when retail banks are competing for new, high-value customers. Respondents recognize that the branch can be a key source of new business. Seven out of ten respondents say that the majority of their product sales take place through the branch network or face-to-face.

However, despite being a vital channel for sales and advice, branch networks have high fixed costs. By reframing the branch network as a revenue-generating channel,

rather than a cost or servicing center, retail banks can improve the cost-to-income ratio of their branch networks. This might involve the reformatting of branches to increase their focus on sales and advice, the reallocation of resources to branches with higher customer footprints, or the incorporation of technology into branches so that simple transactions can still be completed cheaply and efficiently.

This increased role for sales and advice in branch networks will require new skills and training among employees who meet with customers face-to-face. Yet even more critical than having the right resources in the right channels will be the need to adopt a seamless multi-channel approach. Customers will increasingly expect to be able to jump from one channel to another, and they will want a consistent service regardless of whether they opt to conduct a transaction online, through a call center or in a branch.

Banks need a better understanding of their customer base.

To ensure that they maximize revenues while at the same time keeping costs under control, retail banks need a clear understanding of their most profitable and valued customers. At one level, this means distinguishing between high-income and low-income customers and targeting higher income customers with value-added services that can increase revenue. Among our respondents, more than half expect greater segmentation driven by the overall value of the customer.

However, segmentation needs to move beyond the basic dimensions of income, age and geographic location. Successful banks will, in future, need to supplement their traditional analytics with a better understanding of customers' behavior, lifestyles, attitudes, networks and influencers. This increased personalization will become an important capability for differentiation, but there is no question that it is challenging. Only 28% of respondents think that banks will be able to offer a fully personalized banking service for all customer segments in the next five years.

Of the following scenarios, which do you think will be the most likely to happen in your organisation in the next five years?



Source: EIU and Ernst & Young European retail banking survey 2011

How Ernst & Young can help.

We can help you to transform your retail bank to respond to the complexities of both today and tomorrow. We have the regulatory understanding, customer insight and in-depth knowledge of retail banking operations to help build the retail bank of the future.

Our approach to retail banking transformation is based on taking a customer view. Underpinned by research and industry benchmarks, we focus on improving and lowering the costs of the critical interactions that matter most to customers.

Our research of 20,500 banking customers in 22 markets, *A new era of customer expectation*, combined with this survey of more than 650 senior retail banking executives, has highlighted what matters most to customers and how banks are responding.

Using these findings and our international experience of delivering business transformation in financial services, we have developed a set of tools, accelerators and methodologies to help enhance the customer experience, lower costs and reduce the impact of regulatory uncertainty.

We know that you face unprecedented challenges and responsibilities. At Ernst & Young we believe in securing the present and building and executing robust strategies to help retail banks secure the future.

Adapting to this new landscape will be challenging and the 'winners' will be those who:

- ▶ Rebuild customer trust and loyalty through a seamless, integrated customer experience that relates the bank's customer strategy and the customer proposition with the operations necessary to deliver it
- ▶ Eliminate operational failures, thereby mitigating revenue loss from customer attrition, dormancy and complaints
- ▶ Transform their operations to sustainably reduce costs sustainably through automation, straight-through processing, process elimination, offshoring, scaling and outsourcing
- ▶ Meet the increasingly burdensome regulatory requirements cost-effectively and in line with customer strategy

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