EY Bank Barometer 2017
Costs, efficiency and structural change
Editorial

The financial crisis of 2008 has shaken the very foundations of international financial services markets and triggered a response of unimagined proportions from regulators and central banks worldwide. For some time now, central banks have felt compelled to take unconventional measures, including the introduction of ultra-low or indeed negative interest rates, and have been veritably flooding financial markets with liquidity. Regulators, on the other hand, have imposed far stricter requirements on equity and liquidity in a bid to contain systemic risks and enforce compliance with tax and anti-money-laundering law. Switzerland, as a financial services hub, has not escaped unscathed. Bowing to external pressure, it has gradually relinquished banking secrecy and accepted the automatic exchange of information. It has been pushed into a tight corner.

At the same time, fundamental structural change is sweeping through the financial services sector and transforming the value chain. Digitization is a core driver of this change, posing new challenges for banks. What is more, players from other industries are increasingly encroaching on the market and contesting the core business of established banks. At present, this development is mainly affecting payment services, investment advice and increasingly lending intermediation.

Are banks ready for these challenges? Do retail banks and wealth managers have the know-how and resources to adapt their business models to the new reality quickly enough?

EY Bank Barometer 2017 provides answers to these questions. In November 2016, we surveyed 120 leaders (executive officers) of a number of banks in Switzerland.

Our study finds that, at present, banks are chiefly addressing the challenges by raising efficiency and lowering costs. For the most part, they are pursuing these objectives by streamlining their branch networks and downsizing their workforces. However, conventional measures and standard cost improvement programs are not enough. Structural adjustments are needed to ratchet up efficiency in the long term. Such efforts need to capture the full potential of digitization and apply the concepts of industrialization in the organization’s value chain.

Although the financial services sector has so far dealt remarkably well with the challenges and has proven relatively robust, it is important not to lose sight of the trends that are now rapidly emerging and to prepare for the new reality.

We hope you enjoy reading our take on the subject and look forward to discussing it with you.

Patrick Schwaller
Managing Partner
FSO Assurance

Olaf Toepfer
Partner
Leader Banking
EY Switzerland

1 The Swiss units of the two big banks were surveyed and their input was included in the general analysis, but not in the evaluations by type of bank.
Study design
Study details

- Telephone survey conducted by an independent market research institute
  - (Valid Research, Bielefeld) in November 2016
- Surveyed 120 leaders (executive officers) of a number of banks in Switzerland
- Seventh edition since 2010

### Type of banks

<table>
<thead>
<tr>
<th>Type of banks</th>
<th>2016</th>
<th>2015</th>
<th>2014</th>
</tr>
</thead>
<tbody>
<tr>
<td>Private banks</td>
<td>27 %</td>
<td>39 %</td>
<td>20 %</td>
</tr>
<tr>
<td>Foreign banks</td>
<td>23 %</td>
<td>20 %</td>
<td>11 %</td>
</tr>
<tr>
<td>Regional banks</td>
<td>34 %</td>
<td>29 %</td>
<td>53 %</td>
</tr>
<tr>
<td>Cantonal banks</td>
<td>16 %</td>
<td>12 %</td>
<td>16 %</td>
</tr>
</tbody>
</table>

1) Including asset managers

### Bank size by customer assets

<table>
<thead>
<tr>
<th>Size of Bank</th>
<th>2016</th>
<th>2015</th>
<th>2014</th>
</tr>
</thead>
<tbody>
<tr>
<td>Under CHF 5bn</td>
<td>68 %</td>
<td>55 %</td>
<td>71 %</td>
</tr>
<tr>
<td>Between CHF 5bn and CHF 10bn</td>
<td>13 %</td>
<td>17 %</td>
<td>12 %</td>
</tr>
<tr>
<td>Between CHF 10bn and CHF 50bn</td>
<td>13 %</td>
<td>21 %</td>
<td>10 %</td>
</tr>
<tr>
<td>Over CHF 50bn</td>
<td>6 %</td>
<td>7 %</td>
<td>7 %</td>
</tr>
</tbody>
</table>
2. Market environment of banks
Exceptional macroeconomic parameters

The new millennium has brought with it tremendous geopolitical and economic uncertainty globally. This uncertainty has served to enhance the appeal of the Swiss franc. For several years now, the corresponding appreciation pressure has forced the Swiss National Bank (SNB) to keep interest rates at historical lows – even introducing negative interest rates – and to practically flood the market with liquidity. The money supply has risen dramatically since the start of the financial crisis. These exceptional macroeconomic conditions pose tremendous challenges for banks.

Historically low interest rates coupled with an extremely flat yield curve and the corresponding loss of significant earnings from term transformation operations are eroding margins in conventional banking. Moreover, negative interest rates distort the impulses that steer capital as a factor of production, leading to misallocations of capital and liquidity – with currently unforeseeable long-term ramifications.
Banks have increased their volume of business substantially over the last 15 years. On aggregate, the balance sheet totals of all banks in Switzerland have risen more than 40%. Particularly the banks’ mortgage lending has soared by 84%. And banks continue to attract wealth to their investment business: bank customers’ securities portfolios have risen 50% in the last 15 years.

However, banks have been unable to directly “transfer” this enormous volume growth to the bottom line of their income statements. Quite the contrary: the aggregated profits of banks have actually shrunk 7% in the same period.

Banks face a substantial erosion of margins and a related structural change. Although the number of employees has remained relatively stable so far, the number of banks has decreased by 29% and the number of branches by 17%. This trend is likely to hold steady over the coming years and will presumably begin to increasingly affect employees.
Decreasing earnings – rising costs

Although banks have been able to secure significant volume growth in the last 15 years, especially in the mortgage lending business, earnings in their core activities have at best stagnated. Net interest income remained stable overall, but commission income declined 22% and the result from trading activities by as much as 31%. Costs rose in the same period. Initiatives in the banking sector to lower personnel costs have proven relatively ineffective so far, with personnel expenses rising 7% despite an unchanged workforce size. And non-personnel expenses have even increased 40% in the same period.

Low interest rates together with an extremely flat yield curve and the resulting loss of significant earnings from term transformation operations are eroding margins in conventional banking. At the same time, the wait-and-see attitude of investors is hurting commission income, while the implementation of regulatory requirements is impacting the cost structures of financial institutions.

<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Interest income</td>
<td>23.7</td>
<td>22.5</td>
<td>19.8</td>
<td>23.8</td>
<td>0.1</td>
<td>1</td>
</tr>
<tr>
<td>Commission income</td>
<td>28.9</td>
<td>28.0</td>
<td>24.9</td>
<td>22.4</td>
<td>-6.5</td>
<td>-22</td>
</tr>
<tr>
<td>Trading activities</td>
<td>12.5</td>
<td>11.2</td>
<td>11.8</td>
<td>8.6</td>
<td>-3.9</td>
<td>-31</td>
</tr>
<tr>
<td>Other income</td>
<td>3.7</td>
<td>6.9</td>
<td>5.0</td>
<td>8.9</td>
<td>5.2</td>
<td>141</td>
</tr>
<tr>
<td><strong>Commercial success</strong></td>
<td>68.8</td>
<td>68.6</td>
<td>61.5</td>
<td>63.7</td>
<td>-5.1</td>
<td>-7</td>
</tr>
<tr>
<td>Personnel expenses</td>
<td>-24.1</td>
<td>-26.2</td>
<td>-29.2</td>
<td>-25.9</td>
<td>-1.8</td>
<td>7</td>
</tr>
<tr>
<td>Non-personnel expenses</td>
<td>-13.4</td>
<td>-12.8</td>
<td>-13.3</td>
<td>-18.8</td>
<td>-5.4</td>
<td>40</td>
</tr>
<tr>
<td><strong>Operating expenses</strong></td>
<td>-37.5</td>
<td>-39.0</td>
<td>-42.5</td>
<td>-44.7</td>
<td>-7.2</td>
<td>19</td>
</tr>
<tr>
<td>Amortisation</td>
<td>-8.3</td>
<td>-4.9</td>
<td>-11.2</td>
<td>-12.0</td>
<td>-3.7</td>
<td>45</td>
</tr>
<tr>
<td>Extraordinary revenue</td>
<td>0.2</td>
<td>4.7</td>
<td>4.1</td>
<td>11.2</td>
<td>11.0</td>
<td>&gt;100</td>
</tr>
<tr>
<td>Taxes</td>
<td>-3.8</td>
<td>-4.8</td>
<td>-1.3</td>
<td>-2.2</td>
<td>1.6</td>
<td>-41</td>
</tr>
<tr>
<td><strong>Annual profit</strong></td>
<td>19.2</td>
<td>24.7</td>
<td>10.7</td>
<td>15.8</td>
<td>-3.4</td>
<td>-18</td>
</tr>
</tbody>
</table>

Source: www.snb.ch
Productivity in decline at banks

A gap has emerged between banks and other selected sectors in Switzerland in the period from 2000 through 2015: while revenue and productivity in the construction, metals and food industries have improved substantially, banks have seen a contraction.

<table>
<thead>
<tr>
<th>Food industry</th>
<th>Metal products</th>
</tr>
</thead>
<tbody>
<tr>
<td>2015</td>
<td>2000</td>
</tr>
<tr>
<td>41.8 bn</td>
<td>22.7 bn</td>
</tr>
<tr>
<td>76’300</td>
<td>70’400</td>
</tr>
<tr>
<td>547k</td>
<td>322k</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Construction industry</th>
<th>Banks</th>
</tr>
</thead>
<tbody>
<tr>
<td>2015</td>
<td>2000</td>
</tr>
<tr>
<td>70.9 bn</td>
<td>44.0 bn</td>
</tr>
<tr>
<td>317’300</td>
<td>269’200</td>
</tr>
<tr>
<td>223k</td>
<td>162k</td>
</tr>
<tr>
<td></td>
<td></td>
</tr>
<tr>
<td>2015</td>
<td>2000</td>
</tr>
<tr>
<td>63.7 bn</td>
<td>68.7 bn</td>
</tr>
<tr>
<td>123’900</td>
<td>125’000</td>
</tr>
<tr>
<td>510k</td>
<td>555k</td>
</tr>
</tbody>
</table>

Source: www.bfs.admin.ch

The decline in revenue and productivity at banks is particularly notable when contrasted against other sectors.

A structural profitability problem afflicts the financial services sector – despite the fact that revenue per employee is still at a relatively high level.
3. Development of business operations
Relatively sound results

The vast majority of Swiss banks continue to view the development of business as positive, with 80% (prior year: 81%) reporting improved operating results for the last 6 to 12 months. Only 7% saw a substantial deterioration in results of between 10% and 20%.

The overwhelmingly positive assessment by Swiss banks is surprising, given that the industry faces a variety of challenges, some of which raise fundamental questions. The challenges range from geopolitical uncertainty, to historically low interest rates, through to the persistently low transaction volumes of investors and the increased fragmentation of the value chain owing to digitization. Until now, the financial services industry has managed to navigate this difficult market environment remarkably well. Banks are tapping into the opportunities emerging in their core business. Declining net interest income is partially compensated for by considerable volume growth in the lending business and wider margins in mortgage lending. And Swiss banks continue to attract wealth in the investment business, albeit at narrower margins than in the past.
Continued high level of confidence for the year ahead

«What kind of development do you expect for your organization's operational business in the next 6 to 12 months?»

The majority of banks still look to the near future with confidence: 68% (prior year: 75%) anticipate an increase in their operating result in the coming 6 to 12 months. Such confidence on the part of banks is surprising, given the multitude of factors that weigh on their business: the added cost of implementing tighter regulation, historically low interest rates, pressure on margins and competitors from outside the industry. Banks are proving relatively robust, as many of them have managed to overcome past challenges and earn satisfactory operating results.

However, a new trend is emerging: one-third of banks anticipate a negative development of business going forward.

Of those, 9% (prior year: 4%) expect a marked decrease in earnings. Banks cannot indefinitely rely on their current resilience, nor can they hope for a turn in interest rates any time soon. Instead, they need to draw on innovative solutions to rethink the value chain and industrialize it more thoroughly in order to solve the structural profitability dilemma. It can therefore be assumed that the banks' vertical integration will get shallower and reliance on outsourcing solutions will increase.
Cantonal and regional banks still consider the development of business as relatively positive. In contrast, the confidence of regional banks is faltering as they look ahead to the coming 12 months. Cantonal and regional banks are benefiting from steady demand for mortgages. Volume growth in the lending business allows banks to partially compensate for declines in trading operations. In the last few years, banks have hardly had any major non-performing loans, another factor that has had a positive impact on the development of business so far.

However, business prospects are dimming as structural change looms on the horizon. Two-thirds of cantonal and regional banks still anticipate that their operating result will improve in the next 6 to 12 months. Regional banks in particular are cautious in their assessment of the year ahead. They acknowledge that negative interest in particular, but also the strong franc, will be detrimental to Switzerland as a business hub for some time to come. A clearer picture is emerging regarding the ramifications of the negative interest policy, as they increasingly burden the development of banks. It is also becoming clear that the business of regional banks is not immune against new technologies or contenders from outside the industry.
Private banks in the grip of structural change

Of the private banks surveyed, 35% (prior year: 30%) reported contracting earnings, 16% even reported a marked deterioration. Nor do private banks share the confidence of their industry peers as they look ahead to the development of the coming 12 months: 47% expect the downward trend to continue, the highest value since the survey was first conducted in 2010.

Private banks are in the grip of structural change: costs are on the rise, margins are under pressure. This development is forcing them to rethink their business models. Particularly in cross-border business, profitability is in decline as newly acquired assets generally generate lower margins. The cost structure is deteriorating, and the product mix exerts greater demands.

Private banks have to realign their business models if they are to prevail in the market.

This is in stark contrast to the view of foreign banks. They are generally more positive about the development of business in the past 12 months, and future prospects are brightening. This positive assessment comes as a surprise. A less optimistic result had seemed likely given the elimination of bank secrecy and the introduction of the automatic exchange of information, together with the discontinuation of the minimum exchange rate to the euro. After all, foreign banks are particularly exposed to these developments. The fact that they have so far dealt well with these challenges has apparently buoyed the optimism of the remaining foreign banks as to their continued ability to address future challenges.
Job losses expected

«How do you expect the number of employees in your organization to develop in the next 6 to 12 months?»

The majority of banks surveyed anticipate personnel numbers to remain fairly constant. It should be noted that 15% (prior year: 11%) plan to reduce the number of employees by 5% or more – that's the largest proportion since 2013. At the same time, 28% intend to increase their workforce by as much as 10%.

Cost control or reduction is gaining importance in the banking sector. To achieve this objective, most banks are avoiding recruiting additional personnel despite an increase in business volume. In recent years, some institutions have built up their headcount to comply with ever stricter regulatory requirements. Banks expect to generate more income with the same workforce, thus increasing efficiency.

Given the rising importance of outsourcing, a shift in personnel toward external service providers can be expected in the longer term.
Personnel cuts at private banks

«How do you expect the number of employees in your organization to develop in the next 6 to 12 months?»

The majority of cantonal and regional banks are keeping their headcount stable. In contrast, a growing number of private banks anticipate cuts: 26% (prior year: 10%) expect a reduction in headcount of at least 5%. In private banking, the ratio of cost to earnings is considerably less favorable than at traditional retail banks. Consequently, private banks endeavor to keep their costs in check. They are responding more actively to the pressure on margins and the approaching disruptions.

A different tendency can be seen at foreign banks, where 37% intend to hire additional staff — the highest value since the survey was first conducted. Foreign banks have already lowered their headcount in recent years and streamlined their processes. Against the backdrop of global developments, the importance of holding investments in Switzerland has rallied and foreign banks can take advantage of the benefits offered by Switzerland as a financial services hub.
Negative interest and minimum euro exchange rate
Negative interest augments the profitability dilemma

«In January 2015, the SNB discontinued the minimum exchange rate to the euro and introduced negative interest. What is the impact of this measure on your organization in your opinion?»

Of the banks surveyed, 86% (prior year: 73%) are negatively impacted by the interest rate and exchange rate decisions made by the SNB. The sustained negative interest rates weigh especially heavily on the business operations of cantonal and regional banks; accordingly, these are significantly more critical of the SNB decision compared with a year ago. This development is mainly attributable to the fact that cantonal and regional banks are particularly hard hit by the extremely flat yield curve and the corresponding loss of significant earnings from term transformation operations.

Whereas the industry has learned to deal with the strong Swiss franc, negative interest rates continue to put pressure on the margins of banks, thus instigating a profitability problem. Since there are no signs of an end to the negative interest policy in the near term, banks are faced with the challenge of adequately tackling the negative consequences. In a few isolated cases, negative interest rates have already been imposed on wealthy private investors, a policy that continues to win the approval of an increasing number of the banks surveyed. Note that negative interest rates do not just put the screws on margins, they also distort the impulses that steer capital as a factor of production. This can lead to a misallocation of capital and liquidity, but also to the emergence of speculative bubbles in individual asset classes — with currently unforeseeable long-term ramifications.
Negative interest has far-reaching ramifications

«Which of the following consequences of the sustained low-interest environment do you consider to be the most severe?»

A mere 5% of the institutions surveyed do not see any severe repercussions from the sustained ultra-low interest rate environment. One-third recognize several harmful aspects, particularly the structural profitability dilemma. Apart from the impairment of profitability, the institutions surveyed also see long-term problems in the pension systems and the emergence of speculative bubbles in several asset classes on account of the massive increase in liquidity and the distortion of the impulses that steer capital as a factor of production.
Negative interest rates for wealthy private customers

«Does your organization intend to introduce negative interest in the private customer business as well?»

One-third of Swiss banks still plan to introduce negative interest rates in their private customer business subject to certain preconditions. However, tendencies differ between banks specialized in asset management and retail banks. Of the cantonal banks surveyed, 60% (prior year: 20%) are already considering such a step, while the share of asset-managing banks in favor of such a move is decreasing. However, the majority of Swiss banks still reject the introduction of negative interest rates in the private customer business; 65% rule out such a step (prior year: 70%).

Until now, only few banks have introduced negative interest rates in the private customer business. One reason for the reticence is fear that negative interest rates might prompt customers to withdraw their deposits. The change of sentiment among cantonal banks reflects how many institutions are less and less willing to shoulder the added cost of negative interest rates alone.
Sharp decline in deposits feared

«Assuming Swiss banks were to introduce negative interest rates in the private customer business: Do you expect a strong (> 10%) decrease in deposits (run on the bank)?»

![Pie chart showing the percentage of banks expecting a decrease in deposits for different types of banks in 2016.]

- Private banks: 13% No, 26% Probably not, 35% Probably yes, 26% Yes
- Foreign banks: 4% No, 10% Probably not, 48% Probably yes, 30% Yes
- Regional banks: 24% No, 30% Probably not, 32% Probably yes, 14% Yes
- Cantonal banks: 6% No, 33% Probably not, 28% Probably yes, 33% Yes

Forty percent of Swiss banks expect a withdrawal of customer deposits of at least 10% if they introduce negative interest rates in the private customer business. Regional banks are particularly wary of a decrease in deposits. A withdrawal of customer deposits of 10% or more would hit the banks hard and could conceivably give rise to major funding risks, since the fixed-interest mortgages with longer terms currently tend to be funded to a large extent with short-term customer deposits. To prevent a run on their deposits, most banks still prefer not to burden their customers with negative interest rates.

The supply of cash has been rising steadily over the last several years (cf. SNB statistics on the development of the money supply, page 8). This development can therefore be expected to accelerate further should more banks decide to start charging negative interest rates in their private customer business.
5. Automatic exchange of information (AEI)
New money compensates for asset outflows

«From 1 January 2017, data have to be collected and reported under the AEI. Have developments in connection with banking secrecy, tax transparency and automatic exchange of information overall led to significant outflows of foreign customers’ assets at your organization?»

Despite the imminent implementation of the automatic exchange of information (AEI), 71% (prior year: 66%) of the institutions surveyed did not register any significant outflows of their foreign customers’ assets in the last 12 months. In fact, the number of banks that have sustained asset losses of 10% or more has actually decreased to 7% (prior year: 11%). A significant release of tension is also evident at private banks: 74% (prior year: 53%) report that they have not seen any outflows of foreign assets worth mentioning.

Banks continue to attract new assets. They benefit from wealth and asset accumulation worldwide and the fact that Switzerland’s competitive advantages – stability and security – are appealing value propositions. However, the new assets under management often yield lower returns than in the past.

In the long term, it remains to be seen whether banks will also still be able to ward off outflows in regularized, cross-border customer relations after such assets are inherited.
Foreign assets largely regularized

«As regards the outflow of foreign customers’ assets, at what stage of the process is your organization in your opinion?»

Of the banks surveyed, 68% (prior year: 70%) state that they have regularized foreign assets. This share has decreased slightly compared with the prior year, indicating that the banks have not made much progress. While cantonal banks have accelerated the process, it appears that private banks need to take action, with 16% (prior year: 17%) having transformed less than half of assets.

Both banks and their customers have accepted the new reality. Foreign customers understand that global standards prevail today in wealth and asset management and that a switch to another offshore banking center is of little benefit in the long term. Switzerland, as a financial services hub, can therefore justifiably hope to continue playing a leading role in the cross-border wealth and asset management business. Particularly in times marked by uncertainty, Switzerland’s attributes as a secure and reliable financial services center are in demand.
As in the prior year, the current edition of our survey again indicates a degree of uncertainty among the banks surveyed. For the second consecutive year, opinions are evenly balanced between those who reject the idea and those who think it likely. However, a thin majority of banks still anticipate that domestic bank customers will also become subject to the automatic exchange of information (AEI). That said, the share has decreased to 51% (prior year: 56%). In the interim, 61% of cantonal banks expect the lifting of bank secrecy, or 65% in the case of private banks. In contrast, regional and foreign banks think it rather unlikely that the AEI will be applied domestically any time soon.

Political attempts to anchor bank secrecy into the constitution will presumably hinder rapid application of the AEI on domestic assets. Irrespective of whether AEI for domestic customers comes to fruition or not, individual institutions in Switzerland are already implementing what is commonly referred to as a white money strategy.
6. Financial market regulation
Financial market regulation is looked on favorably

«Which of the following effects are you expecting for your organization as a result of the new financial market regulation (FIDLEG, FINIG, etc.)?»

The skepticism expressed in the past with regard to the impact of the Swiss Financial Services Act (FinSA) and the Swiss Financial Institutions Act (FinIA) has eased somewhat. This is no doubt partly a result of the adjustments made and the relief granted in the draft legislation in the political process. Banks expect the quality of investment advice to increase. The banks also clearly anticipate improvements in documentation and consumer protection.

However, such improvements come at a price. Of the institutions surveyed, 78% expect bank services to get more expensive. At the same time, more than half of banks expect further restrictions in the product offering.

It also remains to be seen whether the new rules will be recognized as equivalent to the European rulebook.
Brexit does not open a door to the EU market

«Do you expect Brexit and the associated negotiations between the EU and the UK to improve Swiss banks’ opportunities for market access to the EU as a financial market in the long term?»

Access to the EU market is of paramount importance for Switzerland as a financial services hub. Banks have little hope that access will be eased in the course of Brexit negotiations: 69% of respondents do not expect negotiations between the EU and the United Kingdom to create new opportunities for Swiss institutions.

Barely 16% of private banks expect market entry to get easier after Brexit. Market access is important for the latter cluster of banks. A more optimistic view is expressed by cantonal, regional and foreign banks, which are only indirectly affected by the negotiations over EU market access.
7.

Lending business
More expansionary lending policy of banks

«How do you expect the lending policy of Swiss banks in the residential property segment to develop in the next 6 to 12 months?»

Swiss banks are issuing more loans – 66% (prior year: 55%) expect their lending policy to remain unchanged or become more expansionary over the next 12 months. This is the highest score in five years and includes lending both for SMEs and residential property.

The lending policy shows that banks want to develop their lending business further. In the present environment, this segment has become more attractive compared with the trading and investment business, sectors that are suffering from lower transaction volumes. As a result, banks that do not have traditional lending operations are increasingly keen to enter this market. The substantial volume increase in the lending business allows banks to partly offset the decline in margins.
Risk assessment in the lending business going down

«In comparison to the prior year, how much risk provisioning (impairment losses and provisions) will you need to cover your residential property financing business in the next 6 to 12 months?»

Banks see a lower lending risk, with 30% (prior year: 38%) still anticipating an increase in provisions and impairment losses in the next 12 months. In the prior year, more defaults on SME loans had been expected as a result of the discontinuation of the minimum exchange rate to the euro. This nightmare scenario has not materialized to date, and banks are accordingly somewhat more relaxed in this respect than in the prior year. Only 33% (prior year: 45%) still expect to have to increase their risk provisioning.

It can only be hoped that the banks are still right in their assessment. Recent years were indeed marked by a phase without any major non-performing loans, which is unusual compared with the long-term trend.
Imputed lending rate remains unchanged

«In view of the sustained low-interest environment, it seems questionable whether an imputed mortgage lending rate of 4% to 5% is still adequate for calculating acceptability. Do you intend to lower the imputed rate of interest at your organization over the next 6 to 12 months?»

Despite historically low interest rates, banks are holding on to their present mortgage lending practice. A total of 85% of respondents rejected adjustments to the imputed mortgage lending rate, which serves as a basis for calculating acceptability of residential property purchases. Across all categories of banks, a majority do not see any need to loosen the criteria for issuing mortgage loans.

There is no majority in favor of lowering the imputed mortgage lending rate at present, and various banks and regulators as well are explicitly opposed to such a move. Banks are thus helping to prevent the emergence of a bubble in the real estate sector, while at the same time safeguarding against defaults in the event of a rise in interest rates in the long term.
8. Digitization and FinTechs
Potential of digitization still not fully recognized

«The term “digitization” is a popular buzzword at the moment. What in your view is the significance and potential value add of digitization in the financial services business? Which of the following statements best describes the current situation?»

- Digitalization will fundamentally revolutionize the financial services industry
- Digitalization will add an important sales and distribution channel that supplements existing channels
- Digitalization is overestimated hype that will recede again

Only a quarter of Swiss banks recognize the full potential of digitization and expect that the technological advancement may revolutionize the financial services business. Around two-thirds believe that the core of their business will remain intact and that digitization is first and foremost an additional sales channel. In fact, 10% consider it a mere hype.

Digitization will have a fundamental impact on strategies, business models and business processes — not just by augmenting the range of distribution channels, but also by presenting central challenges related to customer touchpoints. Digitization lowers to some extent the barriers to market entry for competition from outside the industry and is expected to lead to a decline in the very strong customer loyalty seen in the past. On the other hand, digitization offers a wide variety of options for individual, personalized analysis of customer data, needs and behavior. Ultimately, this translates to better and more tailored customer advice. In a world that is ever more mobile and personalized, banks not only have to secure customer touchpoints but also learn to make better use of them in future.

In addition, digitization can serve to improve the efficiency of processes and thus address the fundamental profitability problem. It will also be accompanied by the industrialization of suitable processes.
Beginning of fundamental structural change

«In your opinion, is a fundamental structural change (sustained transformation of the value added chain) already taking place in the Swiss financial services industry?»

The Swiss financial services industry is seeing fundamental structural change. A total of 87% of banks already see the value chain undergoing transformation. This is especially clear to private and foreign banks. Structural change is having a particularly strong impact on their core business – investment advice and asset management.

Banks are currently facing an array of challenges, some of which are of a fundamental nature. The historically low interest rate environment combined with a very flat yield curve are reducing margins in the traditional banking business, modest investor activity is hurting commission income and the banks’ cost structures additionally reflect the implementation of regulatory requirements. On top of this structural profitability problem, banks are facing competitors from other industries in individual elements of the value chain and notable technological change.
Investment advice affected by structural change

«Which of the following business areas is affected most by a structural change in your opinion?»

Two business segments are particularly affected by the incipient structural change: investment advice and asset management. The share of banks expecting the largest changes to occur primarily in investment advice is 34%, compared with 28% naming asset management. Interestingly, only 16% of respondents expect payment services to be affected most by a transformation.

The two areas most frequently mentioned, investment advice and asset management, have both traditionally involved a personal relationship. While robo-advisors are not yet significant, there are signs that digital advisory services are gaining in importance at some banks. They range from individual calculation of efficient portfolios to the simulation of scenarios or even ongoing monitoring of investments.

For regional banks in particular, payment services play a vital role. These services are largely standardized and also not regulated as tightly as other areas, making it easier for FinTechs to enter the market with digital offers.

Apparently, deposits and the lending business are unaffected by the structural change: only 4% and 11%, respectively, of the banks surveyed believe that these areas are affected by structural change. The relatively low ranking of payment services may reflect the fact that digitization and structural change are already at an advanced stage in this business.

For regional banks, payment services play a vital role. These services are largely standardized and not regulated as tightly as other areas, making it easier for FinTechs to enter the market with digital offers.
Priorities for 2017
In recent years, banks had been busy above all with the remediation of legacy burdens and implementing stricter regulatory requirements. Risks and regulation were high on their agenda for a long time. Since last year, banks have been able to increasingly shift their focus back toward advancing their core business.

The exacerbated structural profitability problem and structural change are now forcing banks to pay even greater attention to costs and efficiency. This focus has become considerably more pronounced over the past 12 months.

Speedy efficiency enhancements are also needed if the banks are to retain their scope for action. At the same time, the structural change is demanding strategic adjustments, and further investments are required in connection with digitization. Banks are facing the difficult task of addressing all of these challenges at the same time.

Tactical measures to reduce costs will not make for sustainable efficiency gains. Structural adjustments are called for to increase efficiency in the long term. In the process, banks must apply the concepts of industrialization in their own value chain. Such efforts focus on centralizing, standardizing and automating processes.
Outlook through 2020
Intensity of regulation continues

«Where do you see banking in 2020? To what extent do you agree with the following statement?»
In the future, the Swiss banking sector will be substantially more regulated.

Of the banks surveyed, 89% still expect the sector to be substantially more regulated by 2020. This is a very high proportion, considering the new and revised regulations already introduced across the board. In the prior year, the percentage of respondents who held this opinion was 97%.

Regulation will continue to play an important role in the financial services industry. However, many of the fundamental new regulations have been implemented in the meantime, or it is at least known what direction they will take. In addition to stricter requirements concerning equity and liquidity, the new regulations focus primarily on tax transparency, anti-money laundering, cross-border activities, market conduct and suitability issues in investment advice and asset management.
Regulation will remain a key topic for all categories of banks.

All categories of banks agree that the level of new regulations issued will remain high.

Among private banks, the number of institutions that anticipate regulatory pressure to continue to tighten until 2020 is on the rise; two-thirds entirely agree with the statement – the highest value yet seen in this survey to date.
Lower returns

The vast majority of banks surveyed anticipate returns to diminish by 2020 – 92% share this opinion, the highest level since 2012. Returns have already fallen considerably over the past few years, yet banks are expecting them to deteriorate further.

The financial services industry is facing a structural profitability problem with traditional banking business hardly generating sufficient income. As a result, margins are coming under pressure. The continuing low-interest environment is weighing on the industry’s profitability. At the same time, regulation is driving up costs, and banks cannot always pass these on to customers. Banks' returns are lower accordingly.

Mounting pressure on margins is also evident in the asset management business: whereas banks are managing to acquire new money from customers, the returns generated are much lower than in the past. Against this backdrop, banks and investors will have to make do with lower returns for some time to come.

Where do you see banking in 2020? To what extent do you agree with the following statement?

In the future, banks’ shareholders will have to accept lower returns.

I entirely agree
I partly agree
I partly disagree
I entirely disagree

2016


0% 10% 20% 30% 40% 50% 60% 70% 80% 90% 100%
All categories of banks anticipate decreasing returns through 2020. Consensus in this respect is greatest in the private banking business: 97% of private banks and 100% of foreign banks expect sustained pressure on returns.

The optimism expressed by regional banks in the prior year has evaporated, with 87% expecting returns to decrease further. Banks are realizing that their business is coming under pressure from new technologies and providers from other industries.
Consolidation among banks

«Where do you see banking in 2020? To what extent do you agree with the following statement?»

In the future, there will be substantially fewer banking institutions in Switzerland.

In total, 90% of respondents (prior year: 86%) believe that there will be significantly fewer banks in Switzerland by 2020. The number of banks that agree entirely with this statement is continuously rising; since 2012, their share has climbed from 34% to 59%.

The consolidation process in the Swiss financial services industry is expected to pick up momentum again. Smaller banks in particular are feeling the pinch of rising costs and declining margins. The fact is that banks are withdrawing from the market. Between 2000 and 2015, a total of 109 banks – 29% of all banking institutions – disappeared from the market in Switzerland. Some institutions were sold, while others gave up their banking license to focus solely on asset management. Banks are convinced that this trend will continue.
The private banking sector is particularly skeptical about the near future: 97% of private banks and 96% of foreign banks expect a large number of peers to withdraw from the market by 2020. Private banks are most affected by the structural change, whereas foreign banks have been hardest hit by the consolidation to date. The other categories of banks, however, are also seeing increasing consolidation pressure.
Incentive systems under pressure?

«Where do you see banking in 2020? To what extent do you agree with the following statement?»
There will be a fundamental overhaul (and reduction) of remuneration and incentive systems in the banking sector.

Three-quarters of the banks expect a reduction of remuneration and incentive systems in the banking sector by 2020. Consensus on this point has increased again slightly year on year.

Since 2012, banks have been taking a close look at their bonus models, and many of them have already adjusted their remuneration and incentive systems. However, a large majority (three-quarters) realize that further adjustments and reductions will be required in future. The financial services industry still pays above-average salaries and bonuses. With regard to the structural profitability problem that many banks are facing, the question is how long the industry can afford to pay such a high level of remuneration.
All categories of banks agree that remuneration and incentive systems will need to be adjusted by 2020. Among cantonal banks, however, there has been a clear swing of opinions, with the share of banks that intend to overhaul their compensation models rising from 43% to 72%. Cantonal banks are also facing challenges in the current market environment and are having to take a closer look at their costs. This is bringing personnel expenses, which represent a large cost item, to the center of attention.
Competition from outside the industry is a reality

«Where do you see banking in 2020? To what extent do you agree with the following statement?»

Competitors from outside the sector (IT, mobile phone, Internet) will threaten the market position of banks.

Whereas just four years ago, only a minority considered competitors from other industries to present a threat, meanwhile the level has more than doubled to 67%. Competitors from other industries, the IT industry in particular, are putting Swiss banks under pressure.

For a long time, banks have ignored the possibility of competition from outside the industry posing a serious threat – the reality is very different, and technological advancement has made it possible. Now banks are seeing the first non-industry providers entering the market and competing for selected sections of their value chains. With FinTechs, mobile payment apps and robo-advisors, competitive pressure is rising and margins keep falling. Competitors from other industries pose a threat not only for the payment services business, but also for investment advice and asset management in particular.

For banks to prevail, they will need to successfully defend customer touchpoints. It is still unclear which strategies promise success in this regard. The option of entering into an alliance with FinTechs as a fast-track path to developing innovative services appears promising.

Whereas just four years ago, only a minority considered competitors from other industries to present a threat, meanwhile the level has more than doubled to 67%. Competitors from other industries, the IT industry in particular, are putting Swiss banks under pressure.

For a long time, banks have ignored the possibility of competition from outside the industry posing a serious threat – the reality is very different, and technological advancement has made it possible. Now banks are seeing the first non-industry providers entering the market and competing for selected sections of their value chains. With FinTechs, mobile payment apps and robo-advisors, competitive pressure is rising and margins keep falling. Competitors from other industries pose a threat not only for the payment services business, but also for investment advice and asset management in particular.

For banks to prevail, they will need to successfully defend customer touchpoints. It is still unclear which strategies promise success in this regard. The option of entering into an alliance with FinTechs as a fast-track path to developing innovative services appears promising.
Retail banks face challenges

Retail banks are facing the greatest challenges from competitors from other industries, with 83% of cantonal banks and 77% of regional banks seeing their market position threatened. Private and foreign banks are at present still somewhat more relaxed about the new competition.

For cantonal and regional banks, their unique selling point is their regional base, yet as digitization progresses, physical proximity to a bank branch is losing its importance. As a result, these banks in particular are coming under pressure from the new providers’ digital offers.

Payment services play a vital role here. FinTechs focus their innovative digital offers on this largely standardized area, as do international IT corporations. This gives them access to valuable customer data, which are the basis for individual and personalized customer advisory services. The dangers for retail banks are greater than for asset managers in this respect.
Consolidation of the Swiss branch network is continuing, with 95% of the surveyed banks (prior year: 85%) expecting that the number of bank branches will decrease considerably by 2020.

Banks have been streamlining their branch network for years. Between 2000 and 2015, some 640 branches were closed, which is equivalent to a decrease of 17%. The survey shows that this process will accelerate in future. The increased focus on costs is pushing banks to scrutinize their branch network. This trend is being reinforced by the use of new technologies: increasingly, banking services can be used digitally and many customers do not need to visit a bank branch.

If, however, banks streamline their branch network too much, they risk weakening a customer touchpoint. In a world that is ever more mobile and personalized, banks have to learn to make better use of customer touchpoints. This explains why some banks are experimenting with alternative approaches such as video advice in order to replace traditional branches.

«Where do you see banking in 2020? To what extent do you agree with the following statement?»
The number of bank branches will decrease considerably.
All categories of banks are expecting to streamline their branch network further. It is apparent that the share of those banks that entirely agree with this statement has increased – across all bank categories, this value is 50% or higher.

It is surprising that cantonal banks are planning to close further branches. They generally have a geographically limited catchment area and have already streamlined their sales network considerably in the past.
Digitization on the rise – customer loyalty in decline

«Where do you see banking in 2020? To what extent do you agree with the following statement?»
The loyalty of bank customers will decrease considerably.

Customer loyalty is still in decline. In total, 67% (prior year: 61%) of the surveyed banks expect to be confronted with this challenge through 2020.

As a result of digitization and new offers, customers are able to obtain information about products and services more conveniently and faster. Various platforms facilitate comparisons of offers, personal advice is becoming less relevant and the effort involved in changing provider is also much lower. Customer loyalty toward their bank is therefore decreasing – not just among younger customers. To defend their market position, banks will need to find new ways of establishing proximity to their customers.
Declining customer loyalty at all banks

Across all categories of banks, a majority expect customer loyalty to continue its decline through 2020. Although personal contact has traditionally been more significant in asset management, foreign banks are increasingly also expecting to see a decline in customer loyalty. Only among private banks is agreement with this statement lower than the industry average: 19% (prior year: 9%) decidedly disagree with this statement. One reason for this changed sentiment among private banks might be that customer loyalty at private banks is declining at a slower pace than at retail banks. This seems plausible as the intensity and frequency of personal interaction between customers and customer advisors tends to be higher in private banking than in retail banking.
Mounting pressure on prices in the banking business

«Where do you see banking in 2020? To what extent do you agree with the following statement?»
The price of banking services will fall.

Pressure on prices in the banking business is increasing further. In total, 52% of respondents (prior year: 44%) anticipate falling prices for banking services through 2020.

Digitization makes it possible to hit lower price points in the payment services and investment advice segments. The market entry of competitors from other industries also increases pressure on prices for traditional providers of these services.

Just two years ago, some banks were optimistic that price pressure would ease. They had hoped to be able to pass on to customers the additional costs involved in implementing regulatory requirements. In addition, they had intended to boost their income with new fee models. Only few banks take this optimistic view today. It has become more difficult to pass on the additional costs to customers.
High pressure on prices in asset management

Pressure on prices is higher in private banking than retail banking: 65% of private banks and 63% of foreign banks expect the price of banking services to go down through 2020. These banks are feeling the effects of greater tax transparency – while they have succeeded in offsetting the tax-related outflows of assets by attracting new customer deposits, the latter often have a considerably lower margin. Competitors from other industries are putting additional pressure on prices for investment advice and asset management.

Regional banks also anticipate falling prices: because more and more banking services are being offered through digital channels, a bank’s regional affiliation is becoming less important. This results in increasing competition and mounting pressure on prices.
Industrialization and sourcing

«Where do you see banking in 2020? To what extent do you agree with the following statement?»
The industrialization and sourcing of business processes will increase considerably

Banks expect to see the industrialization of the financial services business to continue through 2020. Since 2013, about 90% of all banks surveyed expect business processes to be subject to increased standardization. Accordingly, banks are increasingly recognizing the strategic necessity of industrialization and sourcing. So far, the financial services sector has seen relatively little in the way of industrialization. However, the marketability of processing services is rising continuously.

In terms of standardization and industrialization of business processes, banks still have a lot to do. For several years, they have focused primarily on mastering increased regulatory requirements. In order to solve the structural profitability problem and raise efficiency sustainably, measures are called for that go beyond tactical cost reductions. Banks must apply the concepts of industrialization in their own value chain. Their vertical integration will decrease as outsourcing solutions are implemented on a bigger scale.
All banks seek to optimize their processes

All categories of banks expect that industrialization and sourcing of business processes will increase considerably through 2020. In retail banking and private banking alike, reducing costs is a priority. Optimizing processes and re-engineering the value chain are important steps in this regard.
Key messages
Exceptional macroeconomic parameters

The new millennium has brought with it tremendous geopolitical and economic uncertainty globally. One consequence has been the increasing appeal of the Swiss franc, which has compelled the SNB to introduce negative interest rates and practically flood the market with liquidity. These exceptional macroeconomic parameters pose enormous challenges, which banks have dealt with relatively well thanks to their remarkable resilience. However, the inescapable truth is that, although banks have been able to realize a marked rise in business volume over the last 15 years, particularly in the mortgage market, they have had to shoulder a marked decrease in margins.

Focus on costs and efficiency

Banks are focusing on efficiency improvements and cost reductions. An industrialization drive is evident. This is the banks’ response to the structural profitability problem with which they are confronted. Historically low interest rates, a flat yield curve and the corresponding loss of significant earnings from term transformation operations are reducing margins in the traditional banking business, while the wait-and-see attitude of investors also hurts commission income. Efforts to implement regulatory requirements additionally impact the cost structures of financial institutions. If banks want to retain their scope for action, they will need speedy efficiency enhancements. Tactical measures to reduce costs will not make for sustainable efficiency gains. At the same time, structural adjustments are needed, which will involve banks applying concepts of industrialization in their value chains.

Beginning of fundamental structural change

Fundamental structural change is beginning to sweep through the Swiss financial services sector: margins in the traditional banking business are under pressure, to the point where the lack of profitability is becoming a major problem. Meanwhile, new technologies and providers are breaking up the value chain. In view of the resultant uncertainty, banks are relying on conventional methods and attempting to lower costs by shedding jobs or closing branches. In the long term, however, profitability can only be secured with fundamental adjustments to the value chain and by exploiting the potential of digitization. Banks face the difficult task of addressing all of these challenges simultaneously and enhancing efficiency as structural change accelerates. Banks are still unsure how to solve this dilemma.

Negative interest rates amplify structural profitability problem

Negative interest rates are bearing hard on banks: margins are under pressure, profitability is shrinking. It is important to note that negative interest rates do not just reduce opportunities to earn income, they also distort the impulses that steer capital as a factor of production. This can lead to a misallocation of capital and liquidity – with currently unforeseeable long-term ramifications. Various risk aspects are intensified as a result, such as in relation to deposits and pension systems or in the form of speculative bubbles emerging in individual asset classes. These burdens weigh particularly heavily on the business of cantonal and regional banks, yet the majority of banks still reject the idea of introducing negative interest rates in the private customer business. One reason for this reticence is fear that negative interest rates might prompt customers to withdraw their deposits, thus triggering funding risks, among other concerns.
Full potential of digitization still not recognized

Swiss banks still do not see the full potential of digitization. Two-thirds believe that the core of their business will remain intact and that digitization is first and foremost an additional sales channel. Technological innovation poses fundamental challenges in connection with customer touchpoints: value chains are breaking up, and competitors from outside the industry have lower barriers to market entry to contend with. The financial services sector is struggling to adjust to this structural change. Banks have yet to benefit from the opportunities of digitization that would allow them to industrialize and automate their processes, thus providing lasting solutions for dealing with the structural profitability problem.

Competition from outside the industry is a reality

Competitors from other industries are putting Swiss banks under pressure. Two-thirds of institutions already anticipate a threat to their market position from IT companies. For a long time, banks had ignored the possibility of competition from outside the industry posing a serious threat — the reality is very different. Technological advancement coupled with expected regulatory requirements (open banking) has made it possible. Now banks are seeing the first providers from outside the industry entering the market and competing for selected sections of their value chains. With FinTechs, mobile payment apps and robo-advisors, competitive pressure is rising and margins keep falling. Because they are standardized, payment services are currently more heavily affected than investment advice or lending intermediation. For banks to prevail, they will need to successfully defend customer touchpoints. The option of entering into alliances with FinTechs as a fast-track path to developing innovative services appears promising.

Banks remain optimistic despite structural change

The structural change has done nothing to shake the optimistic outlook held by the majority of Swiss banks for the year ahead. After all, banks have so far demonstrated a relatively high resilience and have managed to overcome numerous challenges quite successfully. Nevertheless, there are worrying signs of a crosscurrent: one-third of banks surveyed expect a deterioration in the future development of business, with some expecting a marked decline. An increasing number of institutions is feeling the pressure of the structural change. Sitting out these disruptions is not an option. Banks cannot indefinitely rely on the resilience they have shown so far, nor can they hope for a turn in interest rates any time soon. Instead, they need to rethink the value chain, drawing on innovative solutions and industrializing it more thoroughly in order to solve the structural profitability dilemma.
Contacts

Patrick Schwaller
Managing Partner
FSO Assurance
Maagplatz 1
8005 Zürich
+41 58 286 69 30
patrick.schwaller@ch.ey.com

Olaf Toepfer
Partner
Leader Banking EY Switzerland
Maagplatz 1
8005 Zürich
+41 58 286 44 71
olaf.toepfer@ch.ey.com
About the global EY organization
The global EY organization is a leader in assurance, tax, transaction and advisory services. We leverage our experience, knowledge and services to help build trust and confidence in the capital markets and in economies all over the world. We are ideally equipped for this task – with well trained employees, strong teams, excellent services and outstanding client relations. Our global purpose is to drive progress and make a difference by building a better working world – for our people, for our clients and for our communities.

The global EY organization refers to all member firms of Ernst & Young Global Limited (EYG). Each EYG member firm is a separate legal entity and has no liability for another such entity’s acts or omissions. Ernst & Young Global Limited, a UK company limited by guarantee, does not provide services to clients. For more information, please visit www.ey.com.

EY’s organization is represented in Switzerland by Ernst & Young Ltd, Basel, with 10 offices across Switzerland, and in Liechtenstein by Ernst & Young AG, Vaduz. In this publication, “EY” and “we” refer to Ernst & Young Ltd, Basel, a member firm of Ernst & Young Global Limited.

© 2017
Ernst & Young Ltd
All Rights Reserved.

ED None

This publication contains information in summary form and is therefore intended for general guidance only. Although prepared with utmost care, this publication is not intended to be a substitute for detailed research or professional advice. Therefore, by reading this publication, you agree that no liability for correctness, completeness and/or currentness will be assumed. It is solely the responsibility of the readers to decide whether and in what form the information made available is relevant for their purposes. Neither Ernst & Young Ltd nor any other member of the global EY organization accepts any responsibility. On any specific matter, reference should be made to the appropriate advisor.

www.ey.com/ch