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Leaner but larger?
Transforming banking

The next decade in banking will see both evolution and revolution. Banks must reinvent themselves, not just to respond to the pressures of today, but to be flexible enough to adapt to the world of tomorrow.

The most successful banks will be those that have transformed their business models. Banks will increasingly focus on profitability rather than revenues. As a result, they will be defined by narrower scope and simpler structures, but greater reach. They will serve fewer customer segments, but some will operate across more markets. They will deconstruct products, stripping them back to their component parts so that customers can rebuild them tailor-made. At the same time, they will introduce new products more aligned to emerging client needs. Some will move to outsource back-office functions that no longer provide a competitive advantage, and some will operate key banking services for new competitors.
Transformation is necessary because banks face an array of stakeholder pressures. They must find a way to deliver improved performance for investors who have tired of high volatility but low returns on equity. In doing so, banks will have to grapple with a low-growth environment across much of the developed world and slowing growth in the emerging world. To fund their transformation, they will need to become simpler and more efficient.

As banks position themselves to deal with a “new mediocre” era of low growth, they will have to continue to adapt to a post-financial crisis environment, where an often divergent global regulatory reform agenda shows no signs of abating and customer trust must be regained. With governments and regulators becoming increasingly assertive, and customers ever more demanding, this will not be easy. And it will be made harder in a world where the best and brightest talent is looking for a career beyond financial services.

At the same time as banks are dealing with these existing pressures, the wider world is changing. The banking industry cannot help but be influenced by four “megatrends” that will cut across all sectors:

1. A global marketplace
2. Digital business
3. Demographic shifts
4. A changing workforce

While some of these factors will merely accelerate the evolution of banking, some of them, such as innovations in technology, are already demonstrating the potential to drive a revolution through parts of the industry. They will also create new markets for banks as customer needs evolve.

Banks will have to reinvent themselves. Those that do, developing the new products and leaner, more flexible business models for the future, will be able to deliver the returns their investors are looking for, even against the headwind of low global economic growth.
Driving transformation in banking

Banking transformation is a multiyear process. In our last *Global banking outlook*, we looked at the short-term changes banks must undertake. Some institutions have barely embarked on this journey, but as they do, they must adapt to an external environment that is far from static. With this in mind, this year’s *Global banking outlook 2015: transforming banking for the next generation* looks further ahead, setting out the five transformation imperatives that banks must embrace in the coming decade.
The quest for profitable growth
We estimate that if the average global bank grew revenues by 17% from FY13 levels, it would be able to deliver a 15% ROE without any further cost reduction. However, six years on from the global financial crisis, a global economic recovery is yet to be achieved. In fact, stagnation in the developed markets and slowing economies in the emerging markets mean the world faces a “new mediocre” era of low growth. This creates significant problems for banks seeking to grow their way back to profitability.

Despite the prospect of continued low economic growth, we see four areas where banks will be able to generate higher revenues over the next decade: targeting new customers in emerging markets; developing new products and acquiring market share in developed markets; funding infrastructure investment; and partnering with non-banks.
Growth in emerging markets: opportunities, but not for all

The emerging markets were a focus of pre-crisis expansion for global banks, but many overreached and have had to exit some of their operations to refocus on their home markets. Despite this, we believe that during the next five years we will begin to see more banks expanding their geographic footprints.

The demographics are compelling. By sheer population size, the emerging world already dwarfs the developed world by five to one. By 2025, the population of Africa and Asia will increase by about 350 million and 450 million, respectively. This population will lead an increasingly urban lifestyle and its financial needs will evolve. Although economic growth in these markets may slow, they will still grow GDP by about 42% over the next five years – almost twice the rate of the developed world. Furthermore, these markets are set to attract increasing investment, and individuals will become more affluent. By 2025, the emerging markets will account for about 55% of the world’s disposable household income, compared to just 40% today (Figure 1). With this growth come numerous opportunities for banks.

In retail banking, population growth and rising incomes will drive higher demand for transactional banking services. Across low- and lower-middle-income countries, 39% of those currently without bank accounts don’t have them because their incomes are too low. As individuals become increasingly affluent, however, demand for bank accounts will rise. In addition, greater urbanization alone will result in a further 40 million bank accounts being opened in China in the next decade, and 15 million in Nigeria, according to estimates by Oxford Economics. We also expect further urbanization in emerging markets to increase consumer demand for credit – especially to finance the purchase of cars and houses. The growth of the wealthy will also create opportunities for banks. In the past decade, the number of emerging-market billionaires has grown sixfold, and their wealth has risen six and a half times. This new elite will demand an array of services that many local banks will be unable to provide. Alongside greater banking penetration and increasing wealth, the growth of businesses in the emerging markets, particularly the expansion of trade between regions, will need to be supported by banks. On the face of it, the emerging markets offer an array of opportunities for banks to grow.

However, with domestic players dominant in most of these countries, international banks must consider what more they can offer customers and how they can differentiate themselves from local institutions. Furthermore, many emerging markets are hard to operate in – with legal and regulatory frameworks that do not suit large global banks (Figure 2). An unequal regulatory playing field has accelerated the retreat of some banks from what are now seen as “non-core” markets.

In the longer term, we believe that increasingly formalized economic unions in Asia and Latin America may encourage regional banking unions. If this occurs, it will turn the tide against protectionism and make it easier for banks to operate across these regions. However, banks that have completely exited these markets over the short and medium terms may struggle to re-enter them. In the interim, therefore, it is essential that institutions with global aspirations maintain a toehold.

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1 International Monetary Fund, World Economic Outlook, October 2014.
International banks will need to be selective about which markets they expand into and which market segments they serve. Global institutions will pursue only a few limited business lines, such as wealth management and high-value investment banking, in key markets. This will raise some questions for less advanced economies – who will finance regional trade? Who will fund growth in these markets if the local banks have limited balance sheets and domestic capital markets are not sufficiently mature? Who will provide banking services to an increasingly mobile labor force? Regional banks may be better placed to capture greater trade flows or meet retail banking demand. Alternatively, local players may increasingly have to be supported by government, becoming national champions that may themselves morph into regional champions.

Ultimately, all financial institutions must ask whether their existing product sets work for these markets. What new products might be required? Will they be able to distribute products to customers in rural areas? Might technology or partnerships (with banks or non-banks) help them improve both product ranges and distribution networks? Expansion into new markets is not just about attractiveness but also about suitability. Banks

Figure 2: Ease of doing business rankings (lower scores indicate greatest ease of doing business)

Source: Oxford Economics/Haver Analytics

A global marketplace

Global megatrends. Shaping the world, shaping banking.
must identify not only growth opportunities, but also where the regulatory environment will allow them to operate profitably (see “Defining the structure of a bank”). Before the crisis, banks overreached; what they do now must be different: they must be more selective.

**Growth in developed markets: efficiency, market share and new products**

In developed markets, the short-term focus is likely to be profitability rather than revenue growth as banks try to address structurally higher cost bases. This is particularly important in stagnating European economies (Figure 3). To achieve this, banks will need to focus on improving both efficiency and productivity (i.e., cost and revenue per employee). Despite an emphasis on cost reduction, overall efficiency and productivity at many banks in developed markets have deteriorated since the crisis.

In the near term, in the low-growth economic environment of most developed markets, we expect the overall revenue pool for banks to stay constant. However, revenue growth will be achievable for individual banks that are able to increase their share of wallet. This means there will be winners and losers. The winners will be those that are able to significantly improve their customer propositions. This is highlighted in EY research showing that 30% of corporate banking customers saw one of their top challenges in dealing with banks as bureaucracy and a lack of flexibility. Banks will also need to improve trust. A recent report noted that 87% of UK small and medium-sized enterprises (SMEs) believe banks act only in their own best interests, not those of their customers. Recent retail, commercial and corporate banking scandals will reinforce that sentiment. Only by transforming customer experiences will banks be able to materially grow their share of wallet.

Over the medium term, banks can also achieve growth by developing products that cater to new customer needs. The rich world is getting older, and financial products that help the elderly release their wealth — often tied up in housing — will be ever more important. Although some such products already exist, they are often considered poor value. Similarly, the young in the developed world face increasing costs, including those for university and housing. With higher capital requirements, banks will have to find new ways to offer finance to such individuals — while reducing balance sheet risk, if possible.

**Growth through funding infrastructure: increased fees**

Infrastructure funding also offers growth opportunities. Estimates suggest that about US$57t will be required for global infrastructure investment by 2030. This represents about 60% of total assets under management (AuM) in funds (Figure 4). Both developed and developing economies have major requirements for infrastructure, but banks may be challenged by the renewal

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2 EY Corporate Banking Survey, 2013.
of aging infrastructure in the former and development of new infrastructure in the latter. With increasingly constrained balance sheets, banks may be uncomfortable taking the risk of financing such long-term projects onto their balance sheets. However, there are still opportunities for them to grow their revenues while supporting these projects.

Banks can play a leading role in funding major projects in the early stages – when the funding demand is smaller, but the programs are not yet sufficiently mature for major fund managers to invest in. This may be through direct lending or, in regions where the capital markets are less developed, banks may do it by creating onshore investment opportunities for an increasingly affluent population.

In the later stages, rather than lend directly to infrastructure projects, banks can help direct investment from funds. They can work with broader groups of institutional investors, advising them and sharing their expertise in assessing the risks associated with such long-term projects – for example, working with sovereign wealth funds and helping them to identify opportunities to deploy their estimated US$5.2t AuM.

Growth through non-banks: new revenue streams

The fourth growth opportunity we see for banks is in partnership with non-banks. In both developed and emerging markets, we believe there will be opportunities to grow revenues through joining forces with organizations from other sectors. The wealth of data that banks hold on their customers should facilitate a deep understanding of customer patterns and behavior. If they can unlock the value in this data, and convince customers that it is in their interests to let the banks share and use their data, banks can partner with telecommunication, technology and retail firms to offer customers real-time deals on non-financial products, earning fee revenue from partners. There will also be opportunities for banks to increase their revenues and expand their customer base by partnering with new intermediaries (see “A new era of competition”). We also believe that banks will be able to generate additional revenues through fees or cross-selling, or partnerships with central and local governments – for example, as a channel for distribution of welfare payments or collection of local tax revenues, or by providing digital identification mechanisms for government programs. We already see some examples of such partnerships in the emerging markets, such as the Hunger Safety Net Programme in Kenya, and expect this will continue to develop as a revenue source.

Despite fears of an era of low growth, there are opportunities for banks to increase their revenues and boost profitability. Given past mistakes, the challenge for many banks will be to identify the most appropriate ones and to resist the temptation to overreach.
A new era of competition
New entrants have been nibbling at the banking value chain since before the global financial crisis (Figure 5). This has intensified following the crisis as trust in traditional banks has eroded and customers have turned to other organizations to meet their borrowing and investment needs. Some of these organizations have been welcomed by governments and regulators, particularly as a source of finance for small and medium-sized businesses. Banks must respond to defend their position.
We believe it is highly unlikely that these new competitors will be able to completely disintermediate traditional banks. It is currently unclear how far the organizations can expand their business models, and how they would deal with the inherent (and often little understood) risks in new intermediary models that have not withstood a crisis of their own. Nor is it clear that these organizations want to expand their operations so far that they attract significantly greater regulatory attention. The G20 recently announced that it would focus on addressing shadow-banking risks during the coming year and, over the coming decade, we expect increased regulatory scrutiny will lead these organizations to face their own compliance problems.

However, despite the challenges they face, many of these new competitors have shown themselves to be better than banks at using customer information to deliver improved services to clients. Furthermore, greater regulatory scrutiny may even lead to greater trust in these firms, and although some new competitors may exit the marketplace, those that remain are likely to be much stronger. Banks must work out how to adjust to this new competitive environment.
Competition in retail banking

In retail banking, some of the greatest innovation in the past decade has been in payments. Alongside PayPal, which has grown into one of the world’s largest financial services organizations, a host of new innovators have emerged. Payments to small business that used to require a check can now be made by card if the business person carries a smartphone and a dongle. A number of mobile wallet applications for smartphones have been launched in recent years, allowing direct payment to individuals with only a mobile phone number.

Although mobile payments have only recently started to gather momentum in the developed world, they have long been popular in a number of emerging markets that have lacked traditional payment infrastructures. Across these markets there are 251 live and 102 planned deployments of mobile money services for the unbanked, of which only 85 are financial service company initiatives.4

In lending and investments, a number of peer-to-peer (P2P) lending firms have emerged (Figure 6). Without the infrastructure and higher operating costs of traditional banks, including expensive branch networks, these P2P lenders are able to offer greater rates of return to investors and lower interest rates to borrowers.

Figure 6: Cumulative lending by major US and UK P2P organizations (US$m)

There is also increased competition from full-service banks. For example, in the US, we have seen examples of direct banks offering services to customers while using the core banking systems of traditional banks. New bricks-and-mortar banks have also been launched, with a small number of full-service branches in areas with high foot-traffic. These banks have tried to differentiate themselves by offering higher standards of customer service – for example, extended opening hours or faster product application processes – even if they cannot compete fully on price.

This array of new entrants into retail banking is already forcing traditional banks to respond, whether by investing in improved customer service or the technology to deliver some of the services these new players are offering. Although we expect some consolidation of new entrants over the coming decade, they have already transformed customer expectations. We expect this to continue, with customers demanding better pricing and service. Banks will need to make the investments to meet these demands or risk losing business.

Competition in commercial banking

As in retail banking, there has been a revolution in the provision of financial services to businesses. Not only has there been the development of P2P lenders providing debt financing, but also P2P equity investment platforms. In addition, some crowd-funding initiatives offer rewards to investors: rather than prioritizing a financial return, investors pre-purchase products or experiences.

Alongside the headline-grabbing P2P funders, other companies have emerged, including organizations that broker finance between institutional lenders and SMEs through online exchanges and organizations that provide supplier finance and offer online factoring and invoice discounting. Some non-financial companies are also tapping the market directly. For example, one UK retailer raised £50m from its customers through a fixed rate “retail bond” plus gift vouchers over five years. These new competitors have identified gaps in the market. Banks must decide how to exploit these gaps.

Competition in corporate and investment banking

Competition among investment banks is also increasing. With more products like derivatives becoming increasingly commoditized as the over-the-counter market shrinks, institutions face greater margin compression. There is a technology “arms race” too – for example, as banks invest to reduce latency in their order management systems. Ultimately, the expense of competing, combined with declining margins, will lead to companies withdrawing from certain businesses. Only those with sufficient scale will survive.

Additionally, the demutualization of traditional exchanges has created additional competition. In response to what banks saw as increased fees, some investment banks established their own platforms to provide dealing services at lower rates than the traditional exchanges. In response, the traditional exchanges have sought to provide direct access to some investors, disintermediating the banks.

Beyond sales and trading, we expect banks also to face further erosion of their corporate banking business. As banks with constrained balance sheets struggle to lend to large corporates, we expect some funds to be ever more willing to fill this gap.

Although threatened by these new competitors, we believe banks can respond by building partnerships or making acquisitions. They can also become more effective at competing directly. Only in extremis, when they are unable to fund the investments to address this new era of competition, might they have to exit certain business lines.
Changing workforce

Net gain in financial and business services jobs, 2013–30

Global megatrends. Shaping the world, shaping banking.
Defining the new core of a bank

What 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 7), 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%.

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 8). 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

**Figure 8: A customer-driven approach can increase share of wallet**

<table>
<thead>
<tr>
<th>You would</th>
<th>Pay more</th>
<th>Add more products</th>
<th>Increase deposits</th>
<th>Pay more</th>
<th>Add more products</th>
<th>Increase deposits</th>
<th>Pay more</th>
<th>Add more products</th>
<th>Increase deposits</th>
</tr>
</thead>
<tbody>
<tr>
<td>If your bank</td>
<td>Customized products and services</td>
<td>Allowed you to choose from different pricing options</td>
<td>Recommended accounts, products and services that you really need</td>
<td></td>
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</table>
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.
Digital business

1:1
ratio of smartphone users to bank accounts in Vietnam

Global megatrends. Shaping the world, shaping banking.
Technology reshaping banking
In the past decade, technology has completely transformed banking. Over the next decade, it will continue to do so.

While we don’t anticipate many banks making the investment to replace their legacy core banking systems any time soon – in the past decade, barely a handful of banks have re-platformed – we do believe that achieving a digital and technology transformation will require continued investment in middleware. This is critical to drive efficiency, productivity and speed to market. However, to ensure real change, this investment must be strategic rather than solely for tactical fixes.
With only 24% of global IT spend going to investment (less than 20% in Europe), the choice of where to invest will be even more difficult (Figure 9). Nevertheless, it is clear that technology will not only reshape the experience of banking customers, but will revolutionize institutions’ internal processes, making them more efficient and more productive.

**Figure 9: Bang for buck will be critical – spend on new investment (% total IT spend)**

Source: Celent, 2014

Reshaping the customer experience

Many of the changes banks must make to the customer experience will be driven by the growth in mobile and smartphone ownership, which are transforming customer expectations. Mobile payments have already transformed financial services in some emerging markets, where mobile phone ownership significantly outstrips penetration of bank accounts. In fact, in some emerging markets, ownership of smartphones is already beginning to exceed bank account penetration. It is only six years since apps first appeared on mobile devices, and customers now expect to be able to check their balance and make transfers through their phones, at the minimum. Online banking has evolved too – with some banks even offering banking services through Facebook.

Customer expectations have moved beyond “omni-channel” – which has generally been seen by banks as a more consistent multi-channel strategy. They now want to interact with their bank whenever they want, however they want, and wherever they want, and to be able to shift seamlessly between channels. Customers want a ubiquitous experience. In the next decade, we expect to see banks increase their investment in social media as this becomes a more common route to interact with banks. We expect technologies like check and card imaging to become commonplace. We also believe multi-day cycles for re-issue of checkbooks or cards will no longer be acceptable. While some newer, more efficient institutions already have the capability to issue checkbooks and cards in-branch, the evolution of technologies such as digital printing may eventually enable customers to issue their own cards at home – if cards have not been usurped by mobile wallets.

In fact, with smartphone penetration across a sample of 48 developed and emerging markets at almost 45% (up from around 27% in 2011), mobile wallets may become the primary way customers access their bank accounts. At their most advanced, they could offer a single gateway to access multiple accounts across multiple banks. Increased use of smartphones, combined with contactless technology, will potentially transform remittances – for which combined transaction fees and exchange rate margins can still cost more than 10%. They will also transform cash management in these markets. Should mobile wallets with enhanced biometric security become the norm, the cost of obtaining banking services in emerging markets will be dramatically reduced and penetration rates significantly increased.

However, it is not all about a shift to digital channels. While we expect self-service machines to replace cashiers and mobile wallets to become commonplace, we believe branch staff will still have a critical advisory and sales role. EY’s *Global Consumer Banking Survey* 2014 highlights that while digital channels are the most frequently used, they are principally for transactional banking. Customers still rely heavily on personal branch staff for advice, buying and selling investments (Figure 10).

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Nevertheless, the roles of branch staff in retail banking, as well as relationship managers in commercial, corporate and private banking, will be transformed by technology as tablets are increasingly used to deliver their training, provide customer account information and to ensure they stay within a pre-determined sales process. In such instances, technology will not replace people; it will enhance their capabilities and change the ways customers and staff interact.

Critically, as customers expect greater real-time services, some improvements will require cross-industry collaboration. We believe some of the greatest investments will be in real-time payments. The recent advances in mobile payments mean more customers expect to be able to transmit funds instantaneously.

Regulators and governments

US$270 billion

conduct costs and conduct-related provisions for 15 leading banks, 2009–13

A changing world, with multiple stakeholder pressures.
However, these mechanisms only support relatively small transfers. We believe banks in a number of countries will make significant investments to develop real-time, high-value, customer payment.

Better use of customer data will also transform the customer experience. Banks will be better placed to understand customer needs and behaviors. They will have greater connectivity with customers who, EY’s Global Consumer Banking Survey 2012 revealed, would be more willing to give more data to their bank if it led to their being offered more suitable products. With mobile banking apps potentially having access to GPS data, banks will in fact be able to offer personalized, real-time and location-based offers to their customers (see “The quest for growth”).

**Reshaping banking processes**

Changes in customer expectations will force banks to invest in their core systems and processes to make them fit for purpose. But technology spend will not only be driven by customers. Banks will need to make some tough choices about investment priorities.

Banks will deploy a raft of new technology internally. For example, we anticipate increased automation and digitization of processes, reducing the need for manual intervention. We expect greater use of “gamification” to help banks improve governance, and increased use of monitoring and surveillance tools to reduce conduct-related risks. Similarly, the deployment of digital tools such as tablets will help monitor and ensure adherence to sales processes and reduce the scope for misconduct.

Banks will also transform the way they use data internally as they respond to demands from multiple sources. Teams in banks increasingly need more and better-quality data to drive decision-making – whether around resolution of customer issues or internal risk management issues.

Data will be particularly important in dealing with cybersecurity issues, which our European Banking Barometer 1H14 revealed as a top-three priority for major banks. EY’s Global Forensic Data Analytics Survey 2014 showed that 72% of respondents believed big data technologies had a role to play in fraud prevention and detection – but only 2% are already using them (Figure 11).

At the same time, banks are facing increased demand for data from regulators, for example, for the recent Asset Quality Review in Europe, or for the Comprehensive Capital Analysis and Review in the US. Institutions are being asked to make increasingly frequent submissions of increasingly granular data. It has been argued by many that banks should look beyond merely complying with regulations to using these requirements to their advantage to support changing internal processes. To date, the volume and lack of clarity of regulatory change, combined with the cost of dealing with the aftermath of the global financial crisis, have made this difficult. As most post-crisis regulation becomes business as usual, banks will finally be better able to think strategically about how to transform their internal processes and how technology and data will help them do this.

It is clear that technology will reshape banking over the next decade. The challenge for the industry is to shift the balance of technology spend between maintenance and investment to drive internal change and protect against non-traditional competitors.
A changing world, with multiple stakeholder pressures.

Investors

Average ROE of 200 largest banks

Pre-crisis 2005-07 17%
Post-crisis 2011-13 9%
Defining the structure of a bank
Since the global financial crisis, banks have faced increased regulatory burdens. The pressure to reduce risk and complexity, and to enhance resolvability, is forcing banks to rethink their operational structures. Already, some banks have reduced their global footprint. However, increased pressure to grow revenues means many banks will remain committed to offering diverse services and operating across multiple markets. To overcome the operational and regulatory challenges this will create, banks need to ensure they have structures and operating models that are lean and flexible.
Operating across multiple markets

Before the financial crisis, cumbersome and complex legal and operational banking structures grew up as by-products of overseas expansion, acquisitions, changing tax legislation and the development of new banking products.

The traditional approach of banks to operating diverse businesses across the confused landscape of divergent regulatory regimes has been to match complexity with complexity. However, we believe the tide is turning, and leading banks will be those that simplify their structures. In fact, the introduction of Recovery and Resolution Plans (RRPs) in key jurisdictions will compel some banks to reappraise and simplify their entity structures, but we believe that, even when not mandatory, there are benefits in doing so.

The pre-crisis period was one of legal entity proliferation (Figure 12). It is now time to rethink current structures that may no longer fulfill their intended purpose and may magnify risks, lead to inefficient use of resources and unnecessary costs and, ultimately, erode value. Before the financial crisis, one global bank had in excess of 5,000 legal entities across the globe. Such a structure is expensive to maintain. We estimate that the average “carrying cost” of a single legal entity can range from US$90,000 a year for a small entity to over US$600,000 a year for a large entity. Even more troubling, our experience suggests that few at board level truly understand these structures.

Banks that take the opportunity to simplify their structures will benefit from increased operational efficiency, cost savings and compliance benefits. They will also be better positioned to operate and grow in a world where regulatory boundaries are less clear, regulatory demands are increasing and regulators are increasingly assertive and less tolerant of excessively complex organizations.

We also believe that, regardless of business model or geographic footprint, many banks have sub-optimal operational footprints. They must overhaul their operating models. Their core is inefficient and overly complex (also see “Defining the new core of a bank”). Many banks operate business lines supported by their

Figure 12: Complex and costly – illustrative example of a global bank’s legal entity structures
A changing world, with multiple stakeholder pressures.

own separate support functions. We believe that, by breaking out these functions and reshaping them to serve the broader organizations, institutions will be able to drive greater efficiency. They will also build institutional resilience and give regulators greater confidence around their resolvability.

As banks redefine how they operate, they will need to redefine where they operate. We believe that the offshore footprint of global and regional banks is often sub-optimal. In our experience, there has been an optimistic bias among banks (and other institutions) when making outsourcing and off-shoring decisions.

The expected cost savings are, often, initially lower than expected. Furthermore, it typically takes longer than originally anticipated to deliver those savings and to ensure robust processes. In fact, for many banks that have offshored activities, the price of achieving lower costs has been unexpectedly high. Many emerging markets have seen wage inflation that has reduced labor arbitrage benefits. Furthermore, many customers and employees have been disappointed by the quality of offshored services.

Finding the right combination of near-shoring and off-shoring will be critical to banks’ expansion plans. They need to look beyond pure cost factors to develop operations that support competitiveness, innovation, growth and flexibility across back-, middle- and front-office functions.

Regulation will clearly play a part in deciding where to locate operations and activities. Banks must consider global and local regulatory environments – including concerns about how control of data and activities in an RRP world will evolve in the future.

Furthermore, they must be confident about the resilience of local infrastructure and inflation expectations, as well as political and country risks. The availability of talent will also be critical to location decisions.

Our recent discussions with banks across a range of emerging markets have identified shortages of skilled staff as a frustration to their growth ambitions. Such shortages will also become an increasing problem in developed markets, where fewer high-quality graduates want to work in finance. Banks across the world must find new ways to attract leading talent and deploy it where it is most needed.

As banks rethink the markets in which they want to do business over the next decade, so too must they re-examine their operational footprint. It is clear that banks need to simplify their structure, but they must do so in a way that helps achieve efficient growth.

2007 48% 2013 25%

A changing world, with multiple stakeholder pressures.
Existing pressures from stakeholders, combined with the megatrends that are reshaping the world, will transform banks and their business models over the next decade. In some respects, they will extend their reach – expanding into new markets, targeting new customer needs – with more decentralized operations. In many other respects, they will be leaner – nimbler and more responsive to customer demands, refocused around core businesses and capabilities, and “buying in” non-core capabilities.

Redesigned as more flexible institutions, banks will not only be better able to adapt to the changing world, but will also be better placed to respond to unforeseen events in the future. The next decade will be one of transformation in banking. The leading banks will be those that redefine their core operations to support this change and build in the agility to allow them to cope with unexpected global shifts.
new business models
As banks look to grow, they will have to serve new customers—the unbanked in the emerging world and the underserved in the emerging and developed worlds. They will have to develop new products to meet evolving customer needs and find new ways of financing large infrastructure projects. They will also have to partner with other financial institutions, as well as non-banks, to leverage new technologies and generate fees. In addition, they will have to re-engineer to optimize efficiency and productivity, particularly in developed markets.

It will not be a straightforward transition to these new business models. Banks must deliver business-wide transformation. This will be an iterative process as models are continually refined and banks respond to unforeseen developments. As banks embark on these multiyear change programs, they must understand the political and regulatory environment better, they must understand their customers better and, above all, they must understand themselves better.

First, banks must transform in response to regulation. Simplification will be central to this. Banks that take the opportunity to simplify their structures will benefit from increased operational efficiency, cost savings and compliance benefits. They will also be better positioned to operate and grow in a world where regulatory boundaries are less clear, regulatory demands are increasing and regulators are increasingly assertive and less tolerant of excessively complex organizations.

Regulation is also forcing banks to change the way they use and handle data. Yet, institutions that use data and enhanced analytics not just to meet regulatory requirements, but to create insights to meet customer needs, to understand product-level profitability, and to deliver operational excellence will be transformed.

Better data usage will be the foundation for better business models. It will give banks a better understanding of their own core competencies. Knowing where they can create additional value and which competencies are missing—and with a clearer view of costs across the organization—will leave banks better placed to understand which operations they run efficiently and which operations they don’t. Based on this understanding, they can seek additional revenues, whether by partnering with other institutions to provide specific customer products or procure...
managed services, or building alliances and collaborating across the industry to develop industry utilities to help them plug their own capability gaps.

Doing this will also require banks to transform their core technology, investing strategically to deliver business objectives and to circumvent the challenges of legacy systems. They must transform digitally – while mindful of cyber risks – to improve their customers’ experience, to improve customer segmentation and to enhance customer economics. Mobile channels will be central to all of these, especially if mobile can provide a single point of access to multiple bank accounts across multiple providers. However, this will not completely usurp person-to-person banking relationships, and banks must also harness digital to support more effective sales and advisory staff.

It will also be necessary to transform controls and compliance. In the short term, banks must enhance controls across key business processes and strengthen the front office, control function and internal audit to ensure improved compliance. Over the longer term, banks must become more radical by transforming their culture.

Cultural transformation will drive employee behavior that is better aligned to the interests of all a bank’s external stakeholders – governments and regulators, investors and customers. It will also make banks more attractive places to work for a new generation of employees.

But to achieve this, it will be necessary to transform employee propositions. To secure leading talent and comply with regulation, banks must focus on creating compelling propositions for employees that are not based solely on higher-than-average salaries. At an aggregate level, there appears to be little correlation between pay and performance for most bank employees. Furthermore, the “lifestyle” plans proposed by some leading global banks suggest that leadership is out of touch with its millennial recruits. A war for talent between non-banks and banks is already intensifying, and tactical responses are unlikely to tip the balance back in favor of banks.

This will allow banks to differentiate themselves in the marketplace and develop ways to drive productivity and efficiency. Ultimately, the leading banks 10 years from now will not necessarily be defined by the very best products and services or the most efficient operations, although they will score highly on all these counts. They will be defined by their ability to manage the risks of change programs and to make the right investments in products and services. They will be defined by their ability to create an internal culture that weds dynamism to best practice. They will be defined by their ability to deliver new fit-for-purpose business models.

The most successful banks will be those that master transformation.
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