



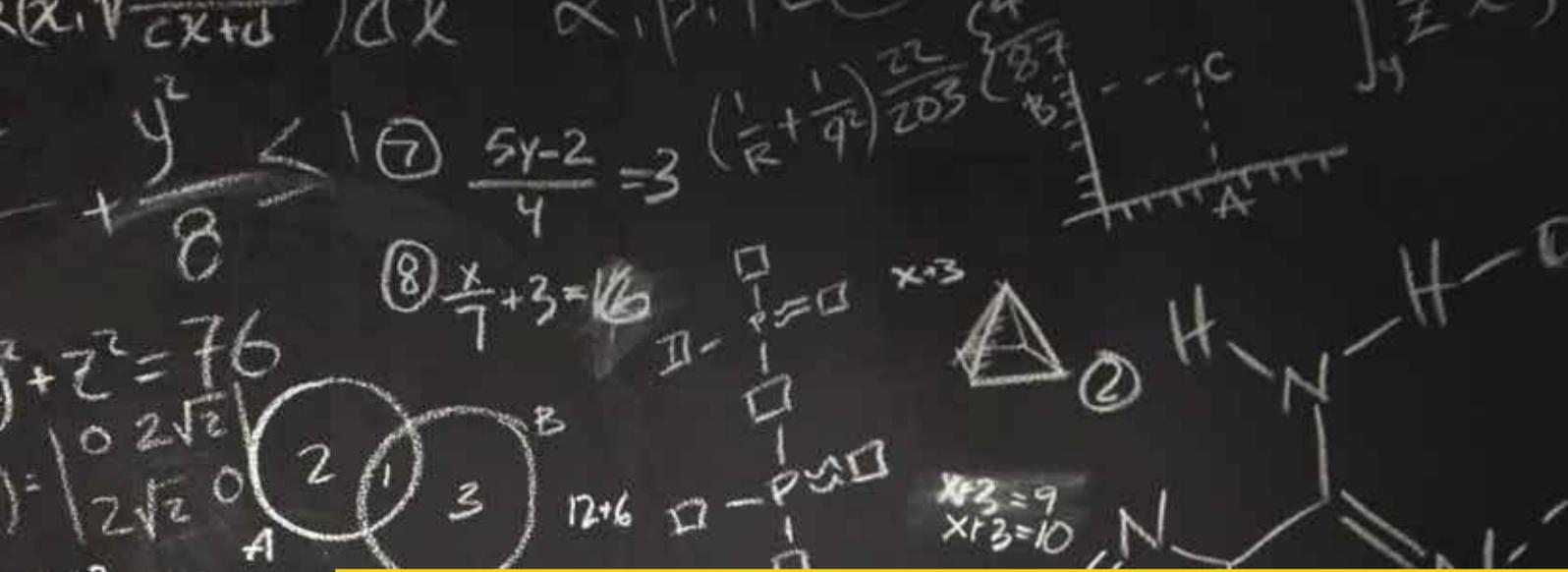
# Transforming banks, redefining banking

Global banking outlook 2014-15

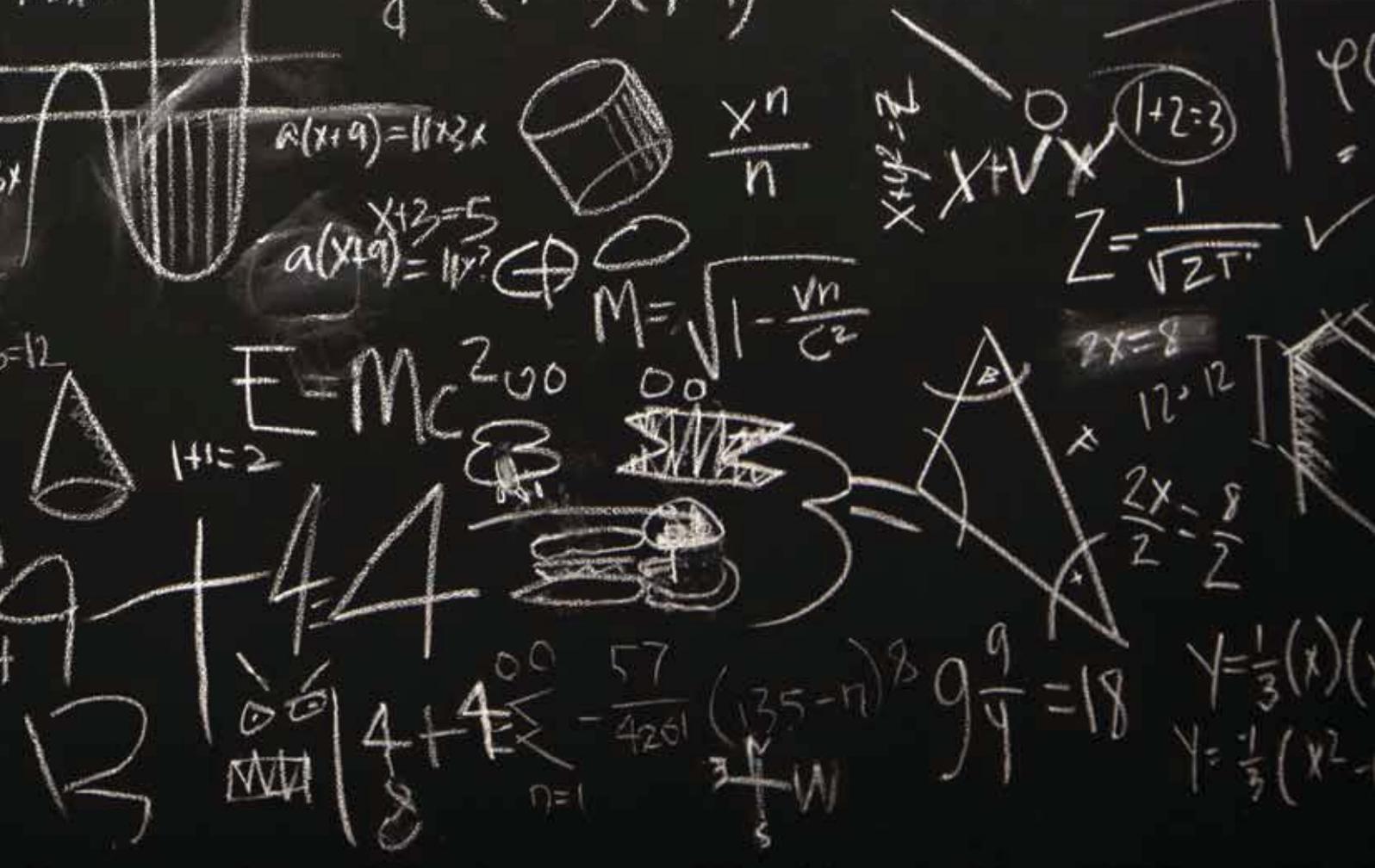
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## Executive summary

“The more things change, the more they stay the same.” That may be true in some aspects of life, but not in the banking industry. At a global level, the scale of change in the industry since 2008 has been unprecedented. The industry is anything but the same.

Banks have been trying to restructure themselves and rehabilitate the industry in the face of significant headwinds. The regulatory rulebook is being completely rewritten, the industry has suffered major reputational damage and major economies have struggled to emerge from recession. Results have reflected these challenges, with return on equity (ROE) at many banks failing to cover the cost of equity.

From an economic perspective, equity markets are nudging record highs, Europe is finally emerging from recession, the US debt ceiling has been raised (at least for a few weeks), “Abenomics” is kickstarting the Japanese economy and China’s growth is improving. Surely that means the economic outlook is positive? Not quite.

Japan’s return to growth is in its early stages and the European recovery is still tentative, particularly in the Eurozone. Banks there are bracing themselves for the European Central Bank (ECB) Asset Quality Review (AQR) and must also contend with the end of the ECB’s long-term refinancing operations, unless they are extended. The debt and budget situation in the US is far from resolved, and the global economy is bracing itself for the impact of tapering when the US Federal Reserve finally starts to wind down its quantitative easing program.

Emerging markets, having benefited from investors in search of yield, may suffer

disproportionately. Yet developed markets will not be immune to the effects of tapering, and banks, many of which have significant holdings in government bonds, will face capital challenges as prices fall.

Complying with new regulations and operating within regulatory constraints has been the first priority for banks and will remain so for some time to come. However, banks must also consider how to meet the expectations of customers, shareholders and markets within those constraints.

On the regulatory front, some rules remain unwritten, especially in relation to structural reform. There is also the potentially counterproductive march to regulatory nationalism. Although the mist has not cleared completely, there is more clarity in key areas and this certainty should prompt more banks to embark on much-needed strategic transformation programs of both business and operating models.

Banks will need to incorporate enough flexibility in their models to respond to new rules as they emerge, essentially developing a strategy around remaining uncertainties. The initial focus is likely to be on “no regrets” investments and initiatives. That’s understandable, but is only a start.

Regulation will remain the primary driver of reform for the foreseeable future, but it is not the only one. We see five unstoppable forces that we believe will drive banks to

change over the next few years (see chart 1). Overlaying all of those forces will be a fluctuating and unpredictable economy.

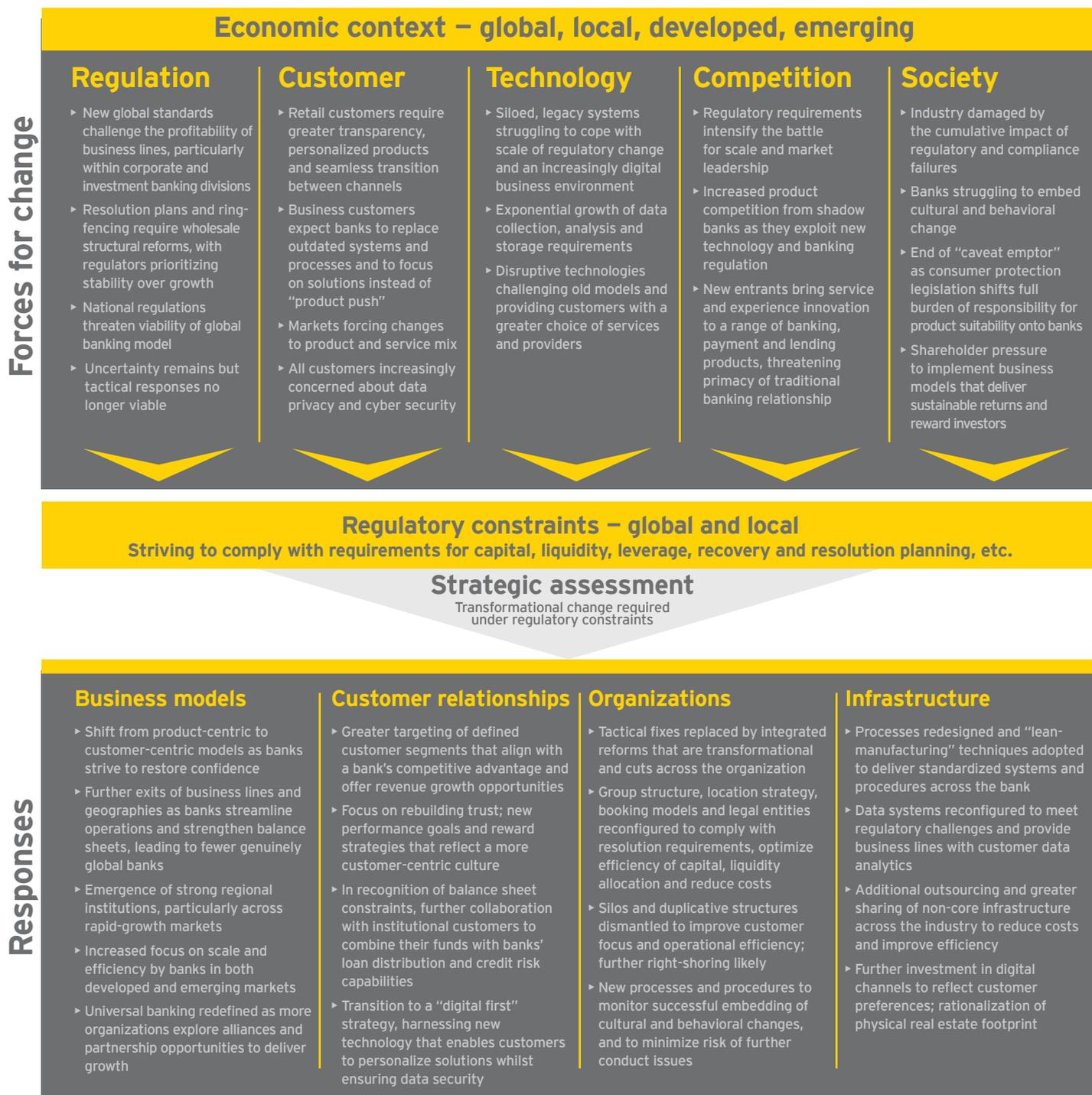
Banks’ responses to those forces will be severely constrained by regulation in all its forms but, with “wait and see” no longer a viable strategy, we expect to see more banks transition from planning to execution, and those responses will coalesce around four themes (see chart 1).

As reforms take effect, the newly redefined banking industry should be able to return to its core functions and support global economic growth. Institutions will be keen to restore both reputation and profitability. Thoughts will turn to growth as banks focus on those aspects of the value chain that provide them with competitive advantage and consider collaboration with others to deliver their new business models more effectively. We also expect close monitoring of progress, particularly in areas such as culture and behavior that are difficult to measure but crucial to sustainable success and to restoring public confidence in the banking sector.

The challenge to this scenario of restored growth and profitability is how national regulators will choose to implement rules for bank recovery and resolution. As their primary responsibility is stability, they may choose shrinking banks deemed “too big to fail” over allowing them to grow.



Chart 1





## Part one: The story so far

Five years on from the tumultuous events of 2008, many aspects of the banking industry are almost unrecognizable from the way they were in the period leading up to the crisis.

Whether it's the fixed income businesses of investment banks, the (mis-)selling of products to retail consumers, the demand for financial services from customers in emerging markets or the scale and intrusive nature of regulation and supervision, the industry has changed and will continue to change for some years to come.

In the aftermath of the global financial crisis (GFC), the initial phase of the industry's recovery took place amid a broader economic recovery. For a short while, banks returned to profitability. Then political crises and concerns about the global economy derailed the recovery. The scale and scope of regulatory reform also became more apparent and, combined, sent returns tumbling – particularly among the European banks.

### **Global economy – mostly on track?**

Fast forward to the end of 2013 and it looks like recovery has finally taken hold in Europe, with both the UK and Eurozone economies emerging from recession. The Japanese economy appears to be waking from its decades-long slumber, thanks to the adoption of "Abenomics."

Fears of a hard landing in China have receded, and growth appears to be more

balanced, incorporating both investment and consumption. The new regime has also initiated some reforms of the banking industry, with tentative steps to liberalize lending rates. Further reforms are expected in 2014.

In the US, GDP growth has been solid enough for outgoing Federal Reserve Chairman Ben Bernanke to float the possibility of tapering the quantitative easing (QE) program. It's not yet clear what impact the US Federal Government shutdown and the standoff over the debt ceiling will have on confidence and growth. But it is possible that the implementation of tapering will only suffer a short delay. (The extent of the delay will be influenced by the success or failure of negotiations in Washington to avoid another debt ceiling standoff in early 2014.)

The delay to date has already proved to be good news for the markets and for some emerging economies. Chairman Bernanke's initial comments in May 2013 about beginning tapering had an almost immediate effect on bond yields and equity prices across many emerging markets. Those with current account deficits and significant levels of foreign debt suffered most and the growth forecasts in these economies have been revised downward for 2014.



The stay of execution before tapering begins has provided time for many economies to enact structural reforms to reduce deficits and improve investor confidence. However, a number of these economies, such as Brazil and India, are also battling inflation and walking a fine line to deliver reforms and growth simultaneously.

There may be more positives than negatives to the global recovery story now, but growth remains far from stellar and, in some markets, less than assured. This lingering uncertainty will continue to have an impact on bank customers' spending and investment plans.

### **Regulation: bite worse than bark**

Back in 2009, the G20 economies agreed to the comprehensive regulatory reform of the banking industry that resulted in the Basel III accord. Yet it has taken several years for politicians and regulators to translate those global standards into national rules and implement other aspects of regulatory reform. Many remain unwritten. In the European Union (EU), the Capital Requirements Directive (CRD) IV was only finalized in 2013 and over half of the rules under the Dodd-Frank Act (2010) have yet to be finalized.

Combined with a sluggish economic recovery, these delays have served as a block on efforts by banks to begin the arduous process of structural reform. Rather than pushing ahead with

transformational change programs, many have opted to wait until more of the regulatory agenda becomes clear. Instead, the focus has been on tactical steps to "fix what's broken."

Most of the final rules have multiyear lead-in times before they take effect. Markets have been much less patient. As we have already seen with Basel III capital standards, banks have been pressured to provide commentary on compliance, and some have been forced to raise additional equity capital. There is an expectation that market pressures will also extend to liquidity and leverage ratio requirements as those are finalized.

One of the biggest challenges so far has been dealing with the chasm that has appeared between global design and local execution. In most cases, the problem has not been regulatory arbitrage; rather, local interpretation and implementation of standards have begun to erode what should have been a globally consistent framework. Potentially even more significant are locally driven initiatives, such as the Foreign Banking Organization (FBO) and Volcker rules in the US and ring-fencing proposals in the EU, that will require major structural reform.

Global banks must deal with additional rules at home, different interpretations of the same rules across jurisdictions and the threat of overreach by home and host authorities incorporating extraterritorial powers into regulations. National supervisors will often have justifiable

reasons for the rules they introduce, but an inconsistent global framework risks damaging the more effective aspects of the international capital markets.

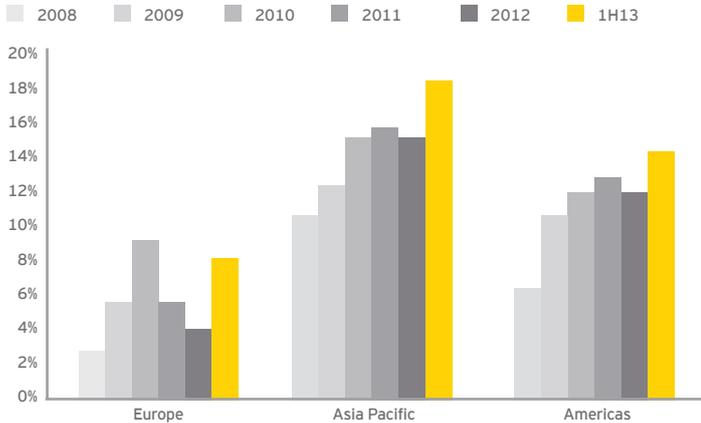
### **Challenges reflected in the numbers**

The economic and regulatory headwinds faced by the banking industry have been reflected in the numbers. In addition to decidedly mixed revenues, banks across regions have also been hit by a series of compliance and regulatory breaches, and by claims related to the GFC, with fines and settlements already running into the billions of dollars and no end in sight.

More recent GDP growth and falling credit losses have enabled some banks to release provisions against loan defaults. Given the flatlining revenues and rising costs across many parts of the industry, these releases have been a key driver of profitability – which clearly is not sustainable. There have also been distinct regional differences in performance.

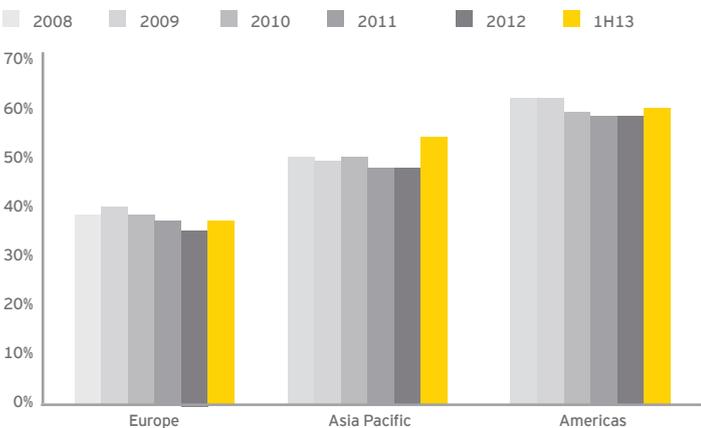
The US banks, having restructured their balance sheets in the immediate wake of the GFC, have been able to take advantage of the domestic recovery and opportunities abroad. Notwithstanding recent concerns in some Asia Pacific economies, banks in the developed and emerging markets of the region have benefited from solid economic growth to deliver some strong performances (see chart 2).

**Chart 2. Average ROE among top 50 global banks, 2008-13**



Source: bank reports, EY analysis.  
See note on page 29 for further information on methodology.

**Chart 3. Average RWAs as a percentage of total assets for top 50 global banks, 2008-13**



Source: bank reports, EY analysis.  
See note on page 29 for further information on methodology.

Indeed, there has been a positive story across most emerging markets over the last few years, reflected in the solid capital base and ROE levels that most banks have been able to maintain. Strong GDP growth has fueled higher wages and increased levels of disposable income, driving consumer spending and demand for financial products from business and retail customers. Government-sponsored investment programs have strengthened cross-sector infrastructure, paving the way for further growth.

However, the emerging markets are not without their challenges. Rising costs are pressuring margins in a number of industries. There is a lack of depth in domestic capital markets that will be a drag on growth, particularly as US QE tapering begins. As a result, banks will be forced to seek opportunities for faster growth, and funding, beyond their traditional bases. We believe significant, further infrastructure investment is needed to reduce reliance on commodities and broaden the bases of these economies. Banks and governments will benefit from collaborating to ensure the financial services sector can promote, rather than hamper, future growth.

Compared to peers elsewhere, European banks have fared less well, as the Eurozone sovereign debt crisis effectively halted recovery in the region. Most banks in developed markets have undertaken some level of restructuring, and risk-weighted assets (RWAs) have fallen (see chart 3). They have exited non-core business lines and sold assets. Some have also acknowledged their lack of market leadership and wound down sub-scale business lines. Unfortunately, all this is still a work-in-progress for many European institutions and they remain weighed down by non-core and underperforming assets.

As noted above, banks have also struggled to deliver top-line revenue growth, as market volatility has deterred activity and customers across many developed markets have continued to pay down debt. The low interest rate environment has continued to squeeze net interest margins, with the Americas banks in our sample seeing a decline of over 15% in the period 2009-13.

The long-awaited recovery of the housing market in the US has spurred growth in the mortgage market, particularly for refinancing. This initial rush has slowed significantly, however, and there are concerns that the threat of higher interest rates once tapering begins will discourage further growth. The European market has also shown some signs of life, supported by policy initiatives such as the "Help to Buy" scheme in the UK. However, many are wary of encouraging too much growth in this sector at a time when interest rates are at an all-time low.

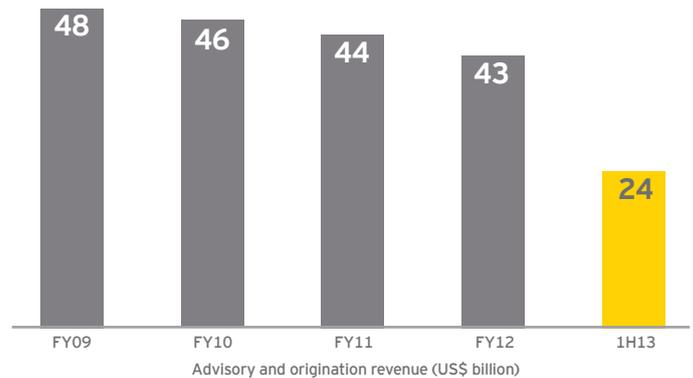
Revenue growth has also been challenged within the investment banking divisions of major global banks. While most products continue to see soft demand, resulting in overcapacity across the industry, others are picking up. Advisory and origination have shown signs of improvement in 2013, with market performance, low rates and investor appetite supporting growth in equity and debt capital markets (see chart 4).

However, trading revenues have been lackluster and profitability squeezed. Capital concerns and the increased price transparency of electronic platforms are driving a continued decline in fixed income, currencies and commodities (FICC) businesses, with revenues down 26% between 2009 and 2012. Poor performances in the second half of 2013 will also have undone gains in the first six months. A partial recovery in equities will not have been enough to compensate, given the size disparity of these business lines (see chart 5).

Although compensation costs have declined as a proportion of revenue for the top 50 global banks (from 33% in 2009 to just under 30% in 1H13), non-staff costs have continued to rise faster than revenues, particularly for European banks (see chart 6). At a total cost level, only the Asian banks in our group have been able to grow revenues faster than costs.

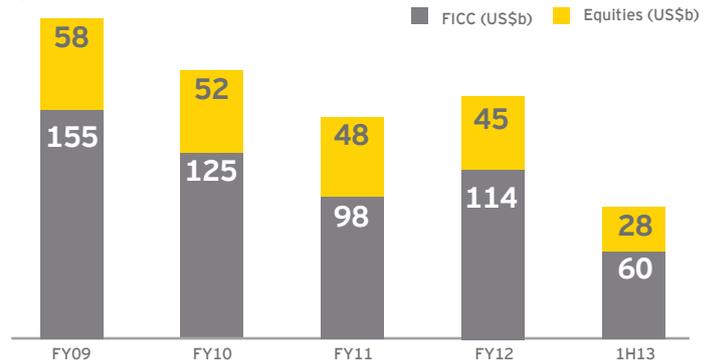
The precise implications may be unknown, but we have already seen what the promise of QE tapering can do to markets, yields and prices. The International Monetary Fund's October 2013 *Global Financial Stability Report* noted that market losses on bond portfolios could reach US\$2.3 trillion as a result of tapering. Its eventual implementation, likely in the first half of 2014, will exacerbate some of the challenges facing banks and make the case for structural reform even stronger.

**Chart 4. Total advisory and origination revenues for global investment banks, 2009-13 (US\$b)**



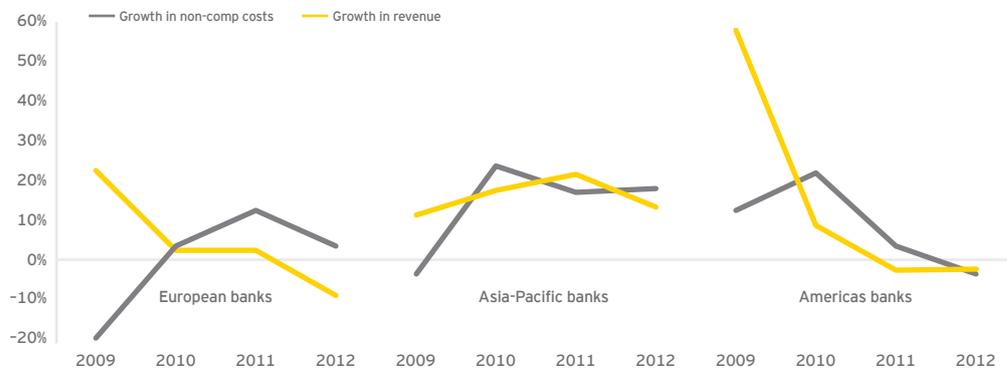
Source: bank reports, EY analysis. See note on page 29 for further information on methodology.

**Chart 5. Total FICC and equities revenues from selected global investment banks, 2009-13**



Source: Bank reports, EY analysis. See note on page 29 for further information on methodology.

**Chart 6. Y-o-Y growth in non-compensation costs vs. revenues among top 50 global banks, 2009-12**



Source: bank reports, EY analysis. See note on page 29 for further information on methodology.



## Part two: Forces for change intensify

Part One highlighted that progress since the end of the GFC has been decidedly sporadic. Banks across many developed markets have struggled to recover.

At the bank and the industry level, much more change is required to deliver strategic restructuring and to deal with overcapacity, both in terms of numbers of banks and the products and services they provide to customers. In emerging markets, banks must consider how to equip themselves for the next phase of growth in the face of rapidly evolving customer requirements and uncertain economic growth.

Responses in the industry have been mixed. We have noted that some banks already have acknowledged the need for change, with transformational reform programs under way. Others are just recognizing the scale of what is required.

Before we consider how banks should be responding to an environment in flux, it's important to understand how those changes are manifesting themselves. What will be the key forces that drive change over the next couple of years and beyond? Why does reform need to cut across

structure and strategy of both banks and the industry? Essentially, why do we need to redefine banking?

Economic shifts will continue to have an influence as the global recovery enters its next phase and trade routes between markets, both developed and emerging, are redefined. Beyond that, there are multiple change drivers, but we have separated them into five core areas:

- A. Regulation: global and local
- B. Customer: demands and expectations
- C. Technology and innovation: enabler, differentiator and disruptor
- D. Competitors: old and new
- E. Society: politicians, citizens, activists

For some, the challenges ahead will be immense. Even for those banks that have begun the process of strategic restructuring, the evolutionary nature of these issues will force many to revisit their plans.



## A. Regulation: global and local

Regulation has been the primary driver of structural change within banking since the full implications of the GFC became clear. This primacy is likely to continue for some time, according to chart 7, taken from a recent EY survey on structural change in European banking. However, the scope and scale of regulatory change affecting banks, particularly those that operate cross-border, are such that a mere tactical response is no longer a viable option.

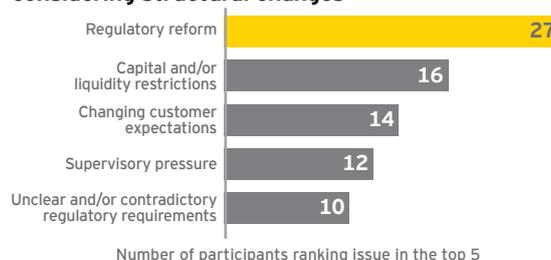
Initially, incremental steps to comply had seemed to be the only sensible response due to the lingering uncertainty and the new rules being developed across multiple jurisdictions. That approach must now give way to a strategic restructuring of business models and operating models.

We have seen already the impact that increased capital charges are having on some business lines, such as FICC. The Institute of International Finance (IIF)/EY 2013 risk management survey, [Remaking financial services: risk management five years after the crisis](#), illustrates this, with the majority of respondents (69%) expecting capital requirements for their trading books to at least double under Basel III (see chart 8).

The proposals from the Basel Committee's second consultative document on a fundamental review of banks' trading books, if adopted, will have further implications in this area. Banks may be required to calculate risks and allocate capital according to a standardized methodology, instead of using an in-house approach. As well as increasing costs, this could also affect the liquidity of some markets as banks choose to hold fewer illiquid assets on their trading books.

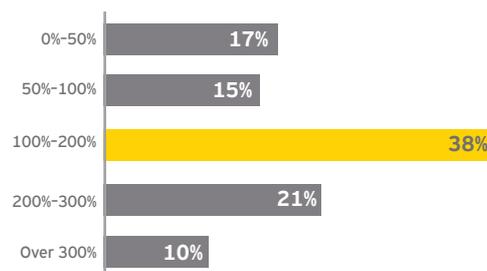
In addition, as a result of over-the-counter (OTC) derivatives reform, most of the banks surveyed also expected capital charges on derivatives to rise by at least 100% as a result of counterparty risk charges alone (see chart 9). With a corresponding impact on ROE (several percentage points), and new margin rules to contend with, delivering acceptable returns will be increasingly elusive for those banks that don't enjoy the scale benefits of market leadership.

**Chart 7. Issues identified as most important when considering structural changes**



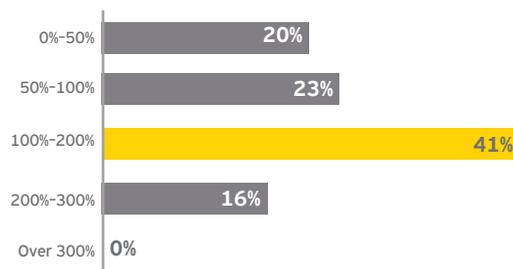
Source: EY/Financial Times survey on structural reform of European banks, 2013.

**Chart 8. Percentage increase in capital requirements for trading book from Basel II to the combined Basel 2.5 and Basel III**



Source: *Remaking financial services: risk management five years after the crisis*, IIF/EY, 2013.

**Chart 9. Percentage increase in capital charges on OTC derivatives for CCR alone (i.e., Basel III CCR charges, including CVA charge relative to CCR charges under Basel 2.5)**



Source: *Remaking financial services: risk management five years after the crisis*, IIF/EY, 2013.



Final rules for liquidity under the net stable funding ratio (NSFR) have yet to be established by the Basel Committee, as have rules for leverage ratios by a number of jurisdictions, including the US. These are likely to drive additional changes to business and funding models. For global banks, the exercise will be further complicated by the increasing preference for subsidiaries over branches by national regulators and potential differences in adoption of liquidity and leverage ratios.

### **Balkanization**

Structural reform, in the shape of ring-fencing and product restrictions, will require banks operating in the US, UK, France, Germany and elsewhere to either cease certain activities or ring-fence them to protect the deposit-taking entity. Across a number of emerging markets, regulators are also implementing much more stringent regimes for foreign banks around capital, liquidity, funding sources and locally housed infrastructure. Combined, these issues will demand a structural redesign of the organization, its systems and processes, and its approach to capital management, liquidity management and governance.

Once national regulators agree upon and finalize recovery and resolution plans (RRP), making banks resolvable is likely to require some major restructuring. But it is not yet clear exactly how far regulators will expect banks to go and whether there will be cross-border acceptance of national resolution regimes. Host jurisdictions may be reluctant to rely on a single point of entry approach and may insist that local subsidiaries be sufficiently capitalized to withstand shocks without relying on capital or loss-absorbing debt from the parent institution in the home country. This may reduce the risk that banks are “too big to fail,” but it will also reduce the efficiency of the global banking system and its ability to support the global economy.

Many of these regulatory initiatives illustrate the seemingly unstoppable march toward balkanization, with global standards giving way to national rules that contradict the stated aim of international cooperation. Variations may be justifiable at a national level, but they will force banks to rethink their global strategies as the playing field becomes much less level.

The benefits of a global banking system are also being threatened by the preference of some governments and regulators for what some term overreach, as evidenced by the US Foreign Accounts Tax Compliance Act (FATCA) and the Eurozone’s attempt to introduce a financial transaction tax (FTT).

The largest 130 banks in the Eurozone will face an additional challenge in 2014 as they undergo the European Central Bank's Asset Quality Review. This is expected to be a much more rigorous assessment of the banks' balance sheets than the previous exercise by the European Banking Authority. Asset sales and additional capital raising to strengthen balance sheets are expected, both in anticipation of and in response to the results.

In the US, the proposals for FBOs above the US\$10 billion asset threshold, if implemented fully, would require affected banks to establish a holding company in the US that would hold the stock of its US subsidiaries. The proposals would also have a significant impact on the capital, liquidity and regulatory reporting requirements of those banks. The compliance and broader business implications will inevitably require some institutions affected by the rules to reconsider their operations in the US.

Beyond prudential regulation, the broader issue of business conduct is becoming a considerable force for change as many banks continue to reel from the effects of multiple failures and breaches. As more institutions have been implicated in issues ranging from anti-money laundering to mis-selling and rate manipulation, a further wave of regulation is likely to deal with conduct risk. Remediation will be time-consuming and expensive as banks examine their own processes, procedures and broader behavioral issues in parts of their organizations.

## B. Customer: demands and expectations

Customer requirements are evolving rapidly. Banks are under pressure from retail and business customers, across both developed and emerging markets, to offer the levels of service and flexibility experienced in other sectors.

In rapid-growth markets, there is also demand for new types of products for the first time. Retail customers are looking for both loan and investment products as income levels rise. For business customers, particularly those looking to expand abroad, demand is growing for hedging products and access to international capital markets. For many domestic banks in these markets, providing these products profitably will be a challenge that requires an innovative response.

There is an increasing expectation across all markets that customers can transition seamlessly between channels and be able to use their channel of choice for different activities, whether they be undertaking simple transactions or seeking advice. More customers are looking to use smartphones for a range of banking and payment activities, including contactless payments and

payments direct from the customer's account to a merchant's account without the use of debit or credit cards. In an era when most customers are multi-banked and switching between providers is increasingly easy, banks must address a number of key issues to protect both the relationship and the stability of their retail funding base.

Transparency on rates and fees is essential, as highlighted in EY's new global survey on consumer banking (due for release in the first quarter of 2014), as are excellent online banking features (see chart 10). However, the top two features that customers are looking for relate to the security of personal and financial information.

**“Beyond prudential regulation, the broader issue of business conduct is becoming a considerable force for change as many banks continue to reel from the effects of multiple failures and breaches.”**

### Under attack

This prioritization reflects concern by customers, regulators and the banks themselves. The nature, speed and sophistication of cyber-crime are evolving rapidly. Hackers operating for financial gain may be the more immediate concern of customers, but “denial of service” attacks that disable systems and delete or steal data are potentially much more damaging.

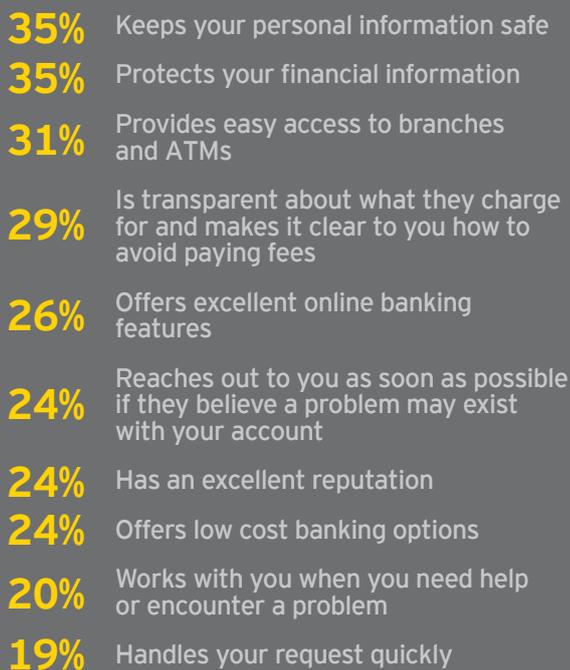
Banks recognize the seriousness of these threats. They also recognize that it is impossible to protect themselves against all attacks and so they must focus on securing the data and systems they regard as their “crown jewels.” However, budgetary concerns and a lack of skilled staff are preventing many from delivering those fixes. This is dangerous for the individual bank but also for the broader financial system, as attackers hunt for the weakest link.

### Suitability

Underpinning a number of the responses outlined in chart 10 is the need for banks to rebuild trust with their customers. Consumer protection agencies across multiple jurisdictions are introducing new rules on suitability, but banks must also demonstrate that they are delivering value and prioritizing long-term customer satisfaction over short-term product sales.

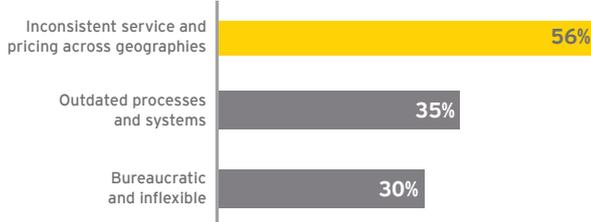
Chart 10.

## Most important key features or benefits sought from primary financial service providers



Source: EY global survey of retail banking customers, to be released in early 2014. Percentage shown is the percentage of total respondents that selected the benefit as one of their top five most important benefits.

Chart 11. Top challenges dealing with banks



Source: *Successful corporate banking: focus on fundamentals*, EY, 2013.

There is also an expectation of change among business and corporate customers. For many, banks are too focused on pushing potentially unwanted products onto them rather than working with them to provide more appropriate solutions. Outdated systems and processes was also raised as a key concern in EY's 2013 survey of multinational corporations, [Successful corporate banking: focus on fundamentals](#). Banks also need to consider how to serve these customers more consistently across geographies (see chart 11).

Banks recognize that they may have been less focused on their customers as a result of multiple business and regulatory challenges. As the EY/Financial Times survey on structural reform showed, changing customer expectations was ranked as the third most important issue as banks consider structural changes to their businesses (see chart 7, above).

## C. Technology and innovation: enabler, differentiator, disruptor

As this section heading suggests, technology will be a crucial driver of change from multiple angles. We have already noted above the importance retail customers place on security, and the threat of data theft and other cyber-crime looms large across the industry.

Yet data is a much broader issue for banks. The amount of data that banks are required to collect, analyze, store and mine is growing exponentially. Even before banks can think about using the data to provide a more effective service to customers, they must overcome the significant burden of regulatory compliance. Tracking and reporting requirements have become much more onerous and legacy systems are struggling to cope.

For example, the Basel Committee's principles of risk data aggregation must be implemented by 2016 and will require major investments in data, systems and reporting capabilities. According to the IIF/EY risk survey (mentioned earlier), nearly 40% of banks expect spending to increase by over 30% in the next two years – and that estimate is just looking at information technology (IT) to support the bank's risk architecture.

As customers become increasingly omni-channel and make greater use of social networks in their interactions with banks, the sources of data are also becoming more complex. With increased connectivity required between channels, and the growth of mobile and online banking, banks are finding that current systems are ill-suited to a more digital business environment. Some banks are starting to lead with a digital strategy, recognizing the brand

benefits of differentiation and the potential savings from driving more activity to lower-cost channels, but these initiatives need to be part of the broader business transformation.

Technology is also enabling new ways for customers to buy banking products and services from new, non-traditional sources. The “disruptive technology” moniker is usually associated with new ways for customers and merchants to exchange payment for goods. As new payment and mobile wallet technologies become more widely used, banks will be in danger of losing transaction fees and prominence in the mind of the customer.

The term also applies to peer-to-peer (P2P) lending, both to retail and business customers. However, it could be applied equally to developments in the capital markets. We continue to see the further “electronification” of sales and trading, and technology is being used to disrupt other aspects of investment banking. The OTC derivatives reforms have proved to be a catalyst for new entrants looking to take advantage of the requirement for these products to be traded on exchange and cleared centrally.

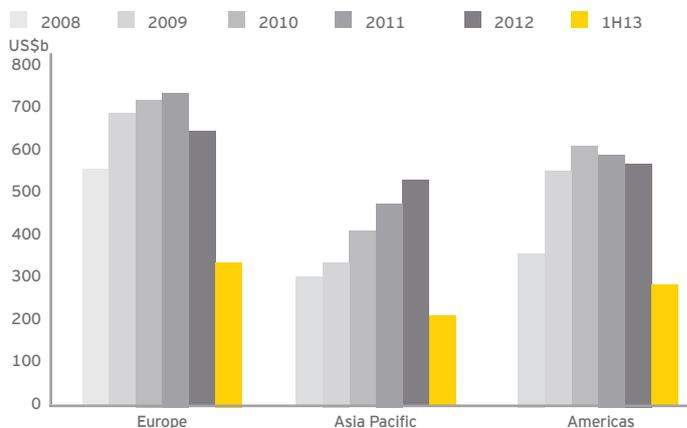
## D. Competition: old and new

Competition has always been a driver of change in any industry. Factor in the issues raised above and it becomes clear that the competitive landscape is likely to look considerably different in years to come.

Much of the focus has been on new, non-traditional players, but incumbent banks will also engender a new-look environment. Particularly where domestic markets are still over-banked, the combination of competitive and regulatory pressures must lead to further reshaping if recent revenue trends are to be avoided in the future (see chart 12). For example, the better-capitalized banks in the Eurozone peripheral economies are attracting deposits from their struggling rivals; at the same time, they are also able to borrow more cheaply from the wholesale markets.

Stronger banks will exploit this advantage to lure customers with better products and rates. International business customers may also be tempted to reconfigure their group of primary banks, as some on the list are no longer able to offer the same product range or geographic footprint. Domestic banks in emerging markets are also likely to face

**Chart 12. Total revenues from top 50 global banks, 2008-13**



Source: bank reports, EY analysis.  
See note on page 29 for further information on methodology.



more severe competition in areas such as corporate banking and wealth management, from regional banks looking to broaden their reach and from global banks in search of growth opportunities.

Capital and regulatory reporting requirements are squeezing the profitability of FICC sales and trading, and it is likely that only market leaders will have the scale to thrive and the funds to invest in the necessary technology. Competition may be intense in the short-to-medium term, but beyond that, only a few banks are likely to survive in a global, multidisciplinary market.

We are also likely to see the emergence of more new entrants, leveraging technology to focus on a particular niche, especially where regulators have imposed restrictions on banks or where the move to use technology is relatively recent, such as in corporate bond trading. Regulation has served as a catalyst for new trading exchanges and swap execution facilities, as well as more non-bank broker dealers. These “shadow banks” may lose some of that advantage over time as they are subjected to more scrutiny. However, the concern for banks must be that, as they are distracted by the regulation and remediation, shadow banking entities will take market share and the move away from the old status quo will be permanent.

Regulation is already driving some change in the payments arena, as banks in Europe, the US and elsewhere are facing restrictions on card transaction fees. Historically, banks would have been reluctant to put this revenue at risk. Now, however, technological innovation may be required to prevent further losses from new competitors.

“The industry needs to change the way it interacts with customers, sells to customers and manages itself.”

The humble current (or checking) account is also becoming an increasingly competitive battleground. Again, technology is playing a part as start-ups use new platforms and outsourcing arrangements to offer a fresh take on banking. It is likely that more retailers will expand their product ranges to include current accounts, in the hope of becoming a customer’s primary financial services provider. Technology and telecommunications firms may also expand the scope of their services to include more financial products.

P2P lenders may only represent a small fraction of the loan market, but the concept is attracting significant attention from institutional investors, which are looking for opportunities to boost yield. As more asset managers establish loan funds, they may use P2P lenders as intermediaries to source borrowers instead of using banks. Recognizing the potential growth opportunities and the type of borrowers that may be attracted to these sites, banks are beginning to work with P2P lenders on larger loan requests.

The broad arena of mobile money is also likely to see much more intense competition as technology and telecommunications firms move further into mobile payments and mobile banking. The loss of fees will be one concern for banks, but more troubling

will be the potential weakening of their relationship with both retail customers and merchants, as digital wallets diminish brand awareness and customer connection.

## E. Society: politicians, citizens, activists

The final driver encapsulates why the other four will lead to significant change within the industry. Indeed, it is society – whether in the form of politicians, shareholders, customers or the media – that has helped to create the environment for the other forces of change to develop as they have.

The cumulative impact on the industry’s public reputation of compliance breaches, product mis-selling, computer failures, data leaks and benchmark rate manipulation is impossible to measure precisely, but it has been severe. Coming after the effects of the GFC, these failings have left confidence in banks at what may be an all-time low.

Customers expect change and investors are looking for credible and sustainable business models. Investors are also looking for the balance of rewards to shift back from managers and employees toward shareholders. Scrutiny from politicians and the media will continue to be relentless. Activism, by both consumers and shareholders is on the rise in both developed and emerging markets.

The pendulum of responsibility has swung far away from caveat emptor to a much more extreme form of consumer protection. Irrespective of whether that swing may be too far, the current environment is probably here to stay for years to come.

As the IIF/EY 2013 risk management survey, [Remaking financial services: risk management five years after the crisis](#), highlighted, banks recognize the need for a behavioral shift in attitude and approach. Conduct has become a major concern, and board directors and chief risk officers are increasingly focused on operational and reputational risk. Banks' risk appetites may be more conservative than they were pre-crisis, but embedding that into the culture is an ongoing process.

The industry needs to change the way it interacts with customers, sells to customers and manages itself. The result needs to be banks that are more transparent and bankers who are more clearly customer-oriented.

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*In addition to the five drivers outlined above, the rate of economic growth – or lack of it – will continue to be a catalyst for change. It will also define the customers, products and markets upon which individual banks will focus. However, while the economic outlook and opportunity will continue to influence strategic direction, we believe these five drivers will be most important in setting the overall strategy in the coming years. The responses that banks need to consider, and that we expect to see over the next 12-24 months and beyond, are outlined in Part Three.*





## Part three: Banks transformed, an industry reshaped

In a constantly changing, increasingly interconnected world, the need for banking services is probably as strong as ever, and even stronger in emerging markets.

However, the organizations that provide them and the manner in which they're delivered is changing. With the myriad challenges and issues forcing the need for change, what response do we expect to see from banks over the next few years and beyond?

When EY and the Financial Times spoke to senior banking executives across Europe to conduct a survey on structural reform earlier this year, we asked banks to categorize themselves now and in the future. For their current business model, 68% described it as universal banking. For their future model, 68% also believe they are likely to use a universal model.

However, how universal banking is defined is likely to change, and not just in Europe. Large banks will be universal in their domestic markets, and perhaps a few other core jurisdictions, but many will need to be much more selective about the services they offer elsewhere. Across emerging markets, banks may strive to provide a universal banking service to their customers but will sometimes lack the resources, technology and distribution capabilities to do so single-handedly. Banks will be transformed as a result and the industry will be redefined.

In the wake of the GFC, the immediate priority for banks has been to comply with the wave of new regulatory requirements on capital, liquidity and leverage and for RRP. Considerable progress has been made but work is not yet complete. The challenge of compliance has already forced banks to rethink their business models as they learned to operate within new constraints. Future ROE targets continue to be revised down. Some banks will face further hurdles as rules on liquidity and leverage are finalized and additional capital is required.

As the regulatory constraints have become clearer, and banks are generally much stronger, the focus is now on having the right business and operating models to serve customers, deliver profitable growth and provide an acceptable return to investors. Some aspects of structural reform are being driven by regulation, such as resolution planning and ring-fencing, but change must go to the core of the business model and responses must reflect all of the drivers outlined in Part Two. There are fundamental, strategic questions that must be answered that will shape the business and determine the extent to which the future bank will indeed be universal.



## Rush to execution?

Most banks have been through that strategic review process since the GFC, some more than once, so they have a reasonably clear understanding of their future business models. Yet many have been reluctant to commit to, and operationalize, the new strategy, for fear of missing a product recovery or underestimating the impact of a business line exit on other businesses. Regulatory and economic uncertainty has also been a major factor in this “wait and see” approach.

However, as discussions at a recent meeting of the [Bank Governance Leadership Network \(EY/Tapestry Networks\)](#) highlighted, the time for waiting may be over. Reshaping large global and regional banks is a multiyear undertaking, and the broad direction of regulatory travel is clear. The pendulum will swing from review to action, although the initial focus is likely to be on “no regrets” investments and initiatives. Banks must incorporate and maintain enough flexibility in their models to respond to new rules as they emerge.

Regulatory constraints will continue to drive significant activity as banks strive to comply with new rules and meet new requirements in areas such as capital, liquidity and leverage. Beyond that initial focus, strategic transformation will coalesce around four core areas:

- A. Business models: redefined
- B. Customer relationships: refreshed
- C. Organizations: restructured (and simplified?)
- D. Infrastructure: redesigned and shared

## A. Business model: redefined

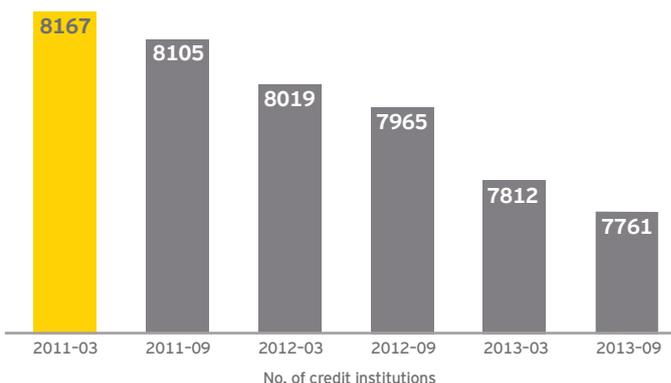
As the final strategic review process takes place, there are a number of factors to consider. Regulation and economic events continue to drive a bigger wedge between weaker and stronger banks, with the latter group able to borrow more cheaply and attract more deposits.

For example, loan-deposit ratios (LDRs) are declining across Europe, but the aggregate figures in the chart below mask the challenges being faced by some institutions, particularly those in the Eurozone’s peripheral economies (see chart 14).

There has already been some consolidation in the European market (see chart 13). Markets such as Spain have witnessed significant restructuring, with over 50 institutions reduced to 12 in three years. We expect to see more in the medium term in those markets that remain overbanked, such as Germany and Italy.

Although the LDR is considerably below 100% in the US (see chart 14), further consolidation also is likely here. Many of the small and mid-size banks will have neither the scale nor the niche attractiveness to win and retain enough business. Hit by the increasing costs of complying and competing and by falling net interest margins, they will struggle to survive without radically reshaping their business models.

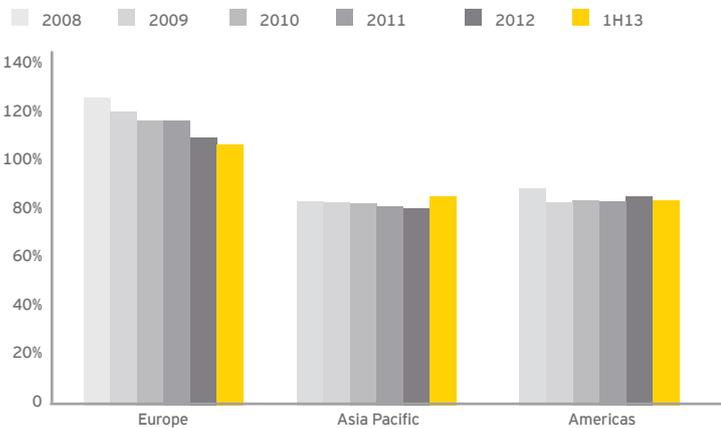
**Chart 13. Consolidation within the European banking sector 2011-13, EU27**



Source: European Central Bank

Banks in emerging markets are also suffering the effects of a low interest rate environment and will be exploring new revenue opportunities to secure new funding capital and maintain returns. Notwithstanding recent policy rate rises to combat inflation, competition is intensifying and banks remain under political pressure to reduce spreads on credit products to retail customers and small businesses. At home, they will focus on product innovation and broadening channel reach to attract new customers, though they must resist the temptation to win volume at the expense of appropriate risk-based pricing.

**Chart 14. Loan-deposit ratio for top 50 global banks, 2008-13**



Source: bank reports, EY analysis. See note on page 29 for further information on methodology.

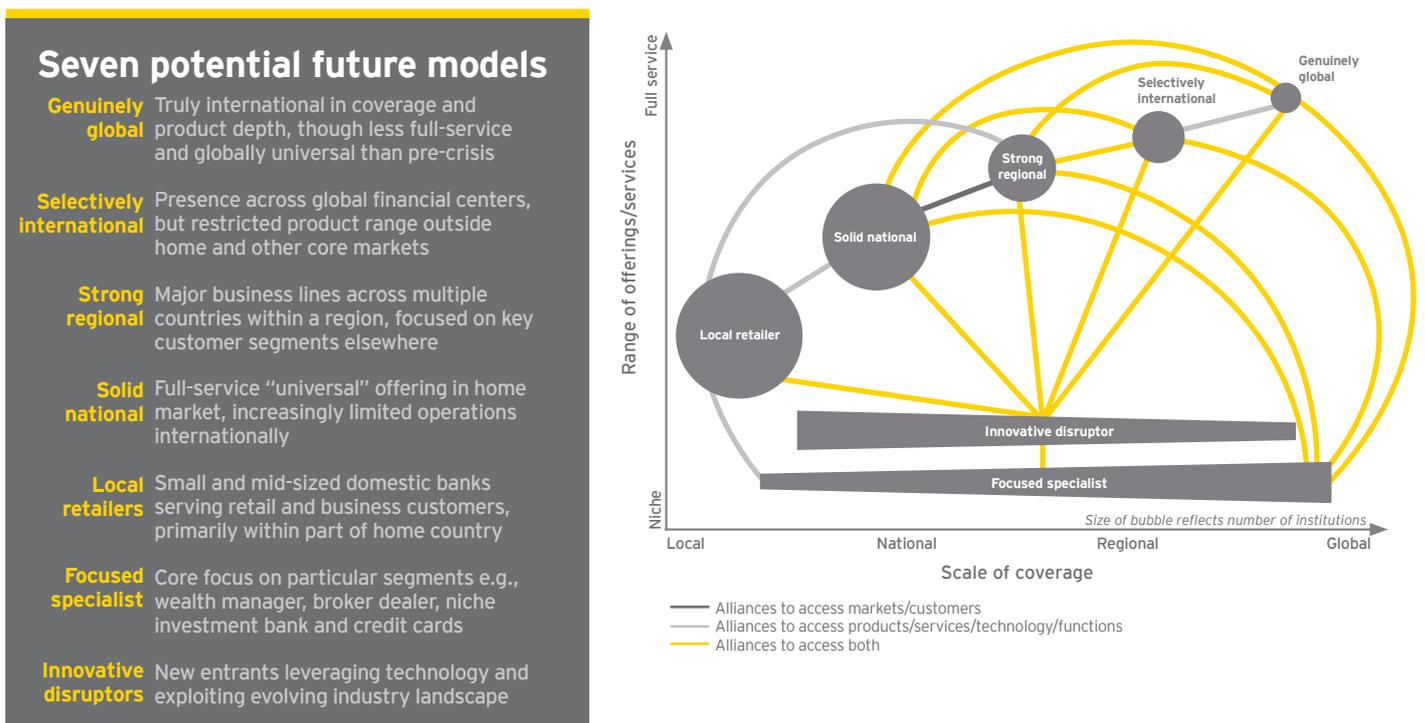
These factors highlight some of the changes we expect to see in the banking landscape. Small and mid-sized banks operating within a single market may continue, but to remain viable, their models will evolve to incorporate alliances and partnerships with others (see chart 15). Stronger national banks will also collaborate with others, and some will look to further targeted expansion abroad.

As EY's June 2013 inaugural issue of *Banking in emerging markets* highlighted the leading banks in Asia, Africa and Latin America are developing regional expansion strategies to exploit the growing demand for financial services in frontier markets and leverage their domestic expertise. They will continue their selective expansion abroad to support their corporate customers and serve key capital and trade flows. Given margin pressure and rising cost inflation, these emerging markets banks will also need to focus on scale and cost efficiencies to maintain viability of the business model.

### Regulation as inspiration

Estimates vary on the cumulative impact of regulation on ROE, but it is impossible to ignore. As chart 16 from the 2013 IIF/EY risk survey shows, more and more institutions are, and will be, reviewing aspects of their business models. Banks will continue to exit business lines and geographies as they streamline operations and strengthen balance sheets.

**Chart 15. Universal banking redefined – seven potential future models as alliances become more important**



As an example, the reforms mandating that OTC derivatives are traded on exchange and cleared centrally will have a significant impact on investment banking revenues, as will new margin requirements. Dominant players are hoping to benefit from scale and recover some lost margin from an increase in volume; for others, recovery options and long-term business viability will be limited.

These changes threaten the viability of global wholesale banking. As a result, we will see fewer genuinely global organizations and the emergence of more strong regional institutions in Africa, Asia and Latin America. These banks will benefit as markets return to stronger growth. Some selectively international banks in markets such as Australia, Canada and Japan, where limited domestic growth opportunities are forcing them to look elsewhere, will also benefit as they continue their expansion into new markets, albeit on a highly selective basis.

The retrenchment across markets and products risks are having a significant impact on customers, as banks that retrench to become solid national banks are less able to fulfil their roles as financial intermediaries and support their customers across different countries and product areas. Banks in

emerging markets are approaching the same problem from the opposite side, as some struggle to meet customer demand for new products and services, such as wealth management and investment banking. As chart 15 shows, alliances with others, whether in the form of informal collaboration or more formal partnerships will become increasingly important.

### Universal 2.0

It is in the rapid-growth markets where we are already seeing examples of how these challenges can be overcome, such as with Japanese banks taking strategic stakes in Vietnamese banks to combine strengths. Based on survey results from EY's emerging markets report (see link above), banks in Indonesia, Malaysia, Mexico and Nigeria are also considering partnerships with genuinely global or strong regional banks to strengthen their product propositions.

Going forward, we expect different forms of partnership to emerge across all markets as thoughts turn to future growth opportunities. Institutions will look to harness their strengths and exploit their competitive advantages while recognizing that they may not be able to satisfy every aspect of customer demand

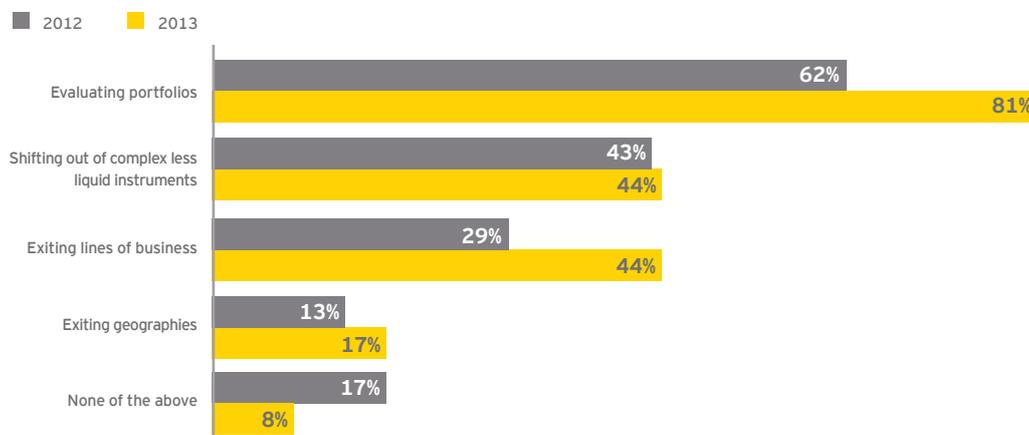
single-handedly. More banks will question whether all products need to be manufactured in-house, and whether they need to both originate and distribute to customers.

Some will hone their position as focused specialists, targeting sub-sectors of the industry such as wealth management, asset servicing, M&A advisory or credit cards. Collaborating with other institutions rather than retaining sub-par business units or committing to major organic expansion programs will provide banks across markets with more agility to respond to new revenue prospects as well as potential economic shocks.

There is potential to extend the open-architecture philosophy beyond wealth management into more vanilla savings and investment products, as well as some credit products. This may be particularly appealing to those local or national banks that are smaller and lack scale. Some new entrants into banking, including retailers, have adopted this approach and focus on the front-end relationship with the customer, contracting with existing banks to provide other services and functions.

In addition to potential white-labelling and third-party sourcing options, there

**Chart 16: Effect of combined liquidity and capital changes under Basel III on business models**



Source: *Remaking financial services: risk management five years after the crisis*, IIF/EY, 2013.

“For banks that need to consider these alternative solutions, perhaps the key dilemma will be determining which parts of the value chain they need to own, and which elements of the overall customer relationship they must retain, if they can no longer own the value chain end-to-end.”

are already examples of banks partnering with telecommunications firms to use new technology to provide customers with offers, discounts and promotions, such as in Spain and the UK. Although banks need to address any data-sharing concerns, there are opportunities here to develop much-needed new revenue streams. We expect to see more banks looking at opportunities to collaborate with each other, and with organizations from other sectors, to provide new products and services to customers.

Some non-traditional new entrants, the innovative disruptors, will be a source of competition as well as potential collaboration. Yet many of them, whether they be shadow banks or technology firms, do not wish to develop the infrastructure needed to run a bank, nor do they wish to become full-scale banks with all of the associated regulatory requirements. Banks may be able to benefit by providing middle and back-office support to these innovative disruptors, and they may also be able to partner with them and benefit from their innovation.

For banks that need to consider these alternative solutions, perhaps the key dilemma will be determining which parts of the value chain they need to own, and which elements of the overall customer relationship they must retain, if they can no longer own the value chain end-to-end. This will vary by institution depending on its competitive advantages, but we think this collaborative approach is a strategy that will suit many banks. Even the genuinely global banks will choose collaboration over organic growth or full-scale acquisition in some markets. The future business model may be universal banking, but it won't be solo banking.

As banks transition to new models and adapt to what will be a lower return environment for many, compensation models will also need to be redesigned. The EU bonus cap makes that both inevitable

and problematic for banks within the Union. Elsewhere, investor demands and supervisory requirements will also push banks to act but they will need to ensure that variable bonuses are not replaced by high fixed salaries.

## **B. Customer relationships: refreshed/restored**

The worldwide focus on greater consumer protection, through legislation and regulation, will change the way banks interact with customers, sell products, reward staff and deal with complaints. As banks across multiple jurisdictions focus on restoring credibility and regaining trust, they must also turn their attention to implementing these new regulations and ensuring that adoption of the broader regulatory agenda supports efforts to restore customer relationships.

### **Which customers?**

One of the broader dilemmas facing banks will be which of its customers to keep relationships with once the new strategy has been implemented. Many banks that have tried to be all things to all customers will find that promise difficult to keep. More are investing in data analytics to develop a clearer picture of the full, risk-adjusted value of a customer's overall relationship with the bank.

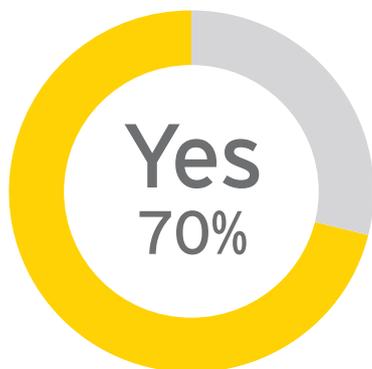
Although no business likes to turn away customers, we may see some institutions take that step and focus on a smaller group of core customer segments where they have genuine competitive advantage. As an alternative, we may also see much greater segmentation across channels, with lower-value customers more reliant on a technology-enabled self-service model with limited interaction with a relationship manager.

## Solutions, not products

That focus is likely to result in more sustainable relationships, and the message it sends to staff will also support the board-sponsored agenda that many banks have to realign culture and behavior. There is recognition that too many sales staff and relationship managers were incented inappropriately in the past. With an increased focus on articulating and embedding a more customer-focused culture, we will also see banks ensure that internal target-setting and reward strategies are aligned to restoring trust and developing long-term relationships with customers.

From a product and service perspective, the priority should be on enabling more personalization and being much more transparent with rates and fees. Bank customers are willing to help banks provide them a more tailored solution. In EY's 2012 global consumer banking survey, 70% of those surveyed were prepared to share more information than was necessary for compliance as long as it resulted in a better service (see chart 17). Most would also ensure the information was reviewed and updated every year.

**Chart 17. Percentage of customers willing to provide their bank with more personal information**



Source: Global Consumer Banking Survey: The customer takes control, EY, June 2012

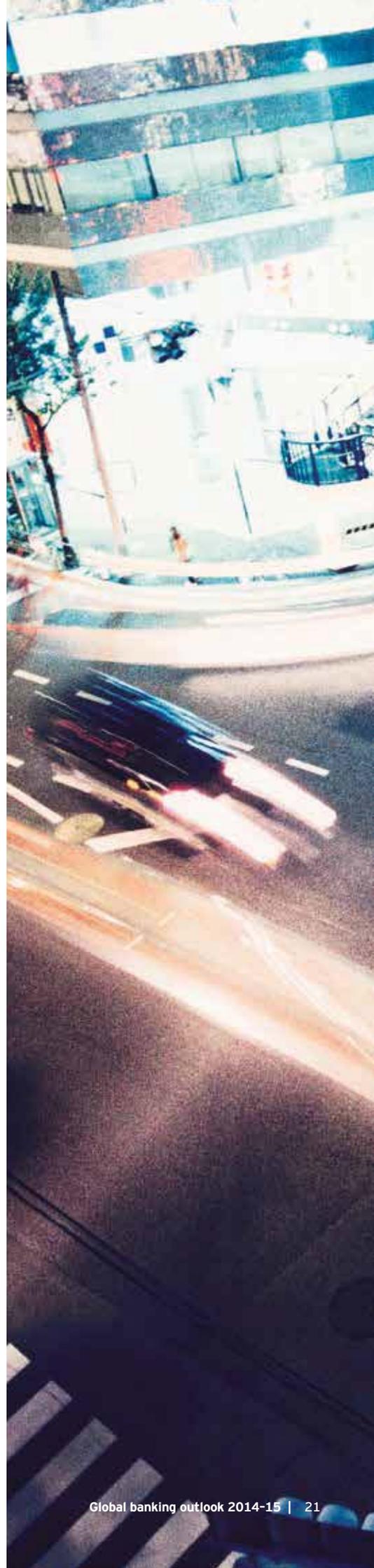
## Growth from digital

Across different sectors such as media, aviation and telecommunications, customers have much more freedom to create a more personalized solution that best suits their needs. Organizations in these industries are leading with a "digital first" strategy, where solutions are developed with mobile and online devices in mind rather than being retrofitted to support those channels. They have a better record than most banks of using customer data effectively. Customers are also experiencing better complaints handling from other sectors; improving effectiveness in this area will boost retention.

As their customers become accustomed to this flexibility and service quality, and start to experience it from new, non-traditional financial services providers, we anticipate that more incumbent banks will follow these examples. They certainly should. Pre-defined bundling isn't necessarily bad, but we expect more banks to respond to customer expectations of greater choice.

Revenue declined by 1.3% in 2012 for the top 50 banks globally. Growth was particularly elusive for banks in Europe and the Americas (see chart 6). As thoughts turn to reversing that trend, complaints resolution, flexibility and transparency will be crucial to retaining customers and increasing share of wallet with them. We also expect banks to learn from others and make better use of the data they have. Banks have a unique view of their customers and yet many lack the data analytics capabilities to turn this into a competitive advantage and provide customers with more targeted offerings and solutions.

Banks will need to reassure customers that online solutions are safe and secure. As we noted earlier (chart 10), data privacy and the security of personal information is a key concern of retail customers, so banks must develop, deliver and communicate



an approach that convinces them. Where banks are using data to offer new solutions to customers, the approach must also convince them that data is handled sensitively and trust is not abused.

### Restructuring for business customers

All customers expect increasingly seamless service throughout the organization, and the speedy and effective resolution of problems. At a time when customers have more choice than ever before, structural reform that complements the new customer strategy is crucial to minimizing attrition.

Aspects of the regulatory agenda, designed to reform bank structures, will have an inevitable impact on business customers, particularly those that require products and services from both sides of a potential ring-fence. The decisions banks make on booking models, legal entity strategy and location strategy in the coming months and years will also affect customers. As banks consider whether to establish an operating entity that serves multiple divisions, use

shared service centers or use industry-wide utilities, it will be critical to understand what impact those decisions would have on different customer groups.

We have already noted that surveyed multinational corporations are concerned about consistency of service across markets (see chart 11), so our expectation is that banks will redesign the structure around customers rather than products and disband potentially artificial silos. It also became clear during that survey that many of these customers don't expect a single institution to meet all their needs. Most are multi-banked anyway and would prefer to select best-in-class providers in each case, which reinforces our belief that banks will become more targeted in both their product and customer strategies.

### Customers as collaborators

More businesses are expecting to refinance loan or debt obligations in the next year, as chart 18 from EY's October Capital Confidence Barometer shows. At a time when interest rates and bond yields are well below historical levels, we are seeing more

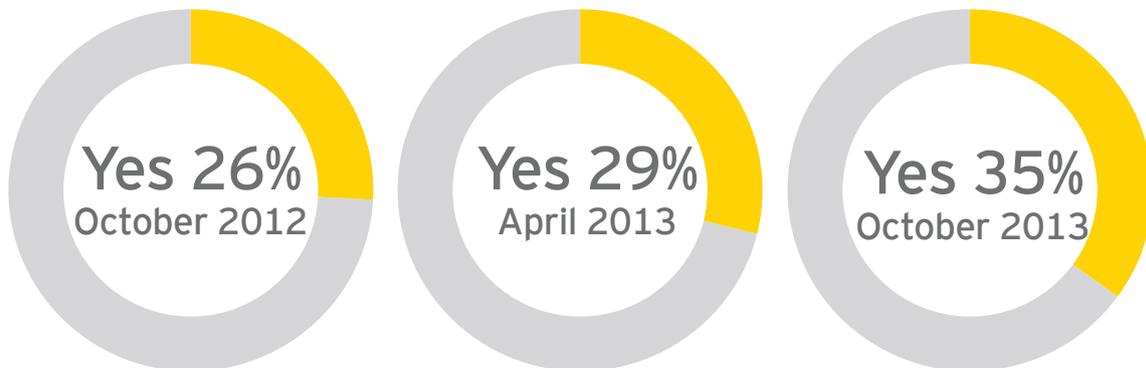
examples of asset managers establishing loan funds or, in the case of a Canadian pension fund, lending directly to companies. Indeed, for low-risk, longer-term projects, a pension fund or insurance company may be a better fit than a bank with a constrained balance sheet.

Banks have the customer base and the skills in loan origination and credit risk management. What many lack is the funds to lend or the capacity on the balance sheet to hold those loans to maturity. We expect to see more examples of banks working with asset managers to harness different skill sets and resources. Given the overdependence on bank lending in Europe and most emerging markets, banks should also be looking at how to help smaller companies secure funding from debt and equity capital markets.

### C. Organizations: restructured (and simplified?)

With significant changes to business models expected over the next few years, existing operating models will also need

**Chart 18. Does your company plan to refinance loans or other debt obligations in the next 12 months?**



Source: EY Capital Confidence Barometer, October 2013.

restructuring. We anticipate a noticeable shift of emphasis as banks transition from planning and tactical fixes to execution of broader, integrated, structural reforms.

Regulation is a significant driver of these reforms in two ways. First, banks will be required to implement certain changes to ensure resolution plans can be executed effectively and to comply with specific rules on ring-fencing. For those banks affected by the proposed rules on FBOs in the US, structural changes will be inevitable to comply and the cost implications may necessitate strategic changes as well. Global booking models are also under threat.

Second, the broader regulatory agenda, as it relates to capital, liquidity and OTC derivatives, makes structural reform an economic imperative. There has been a

permanent step-change in the cost of doing business. Combined, there are multiple incentives to minimize duplication, to improve capital and liquidity efficiency, and to streamline legacy – and often overly bureaucratic – structures. Unfortunately, regulators are more concerned with stability than economic efficiency and some duplication will be inevitable. Partly as a reaction to this, the future operating models for many banks are likely to be simpler, reflecting their withdrawal from different markets and business lines.

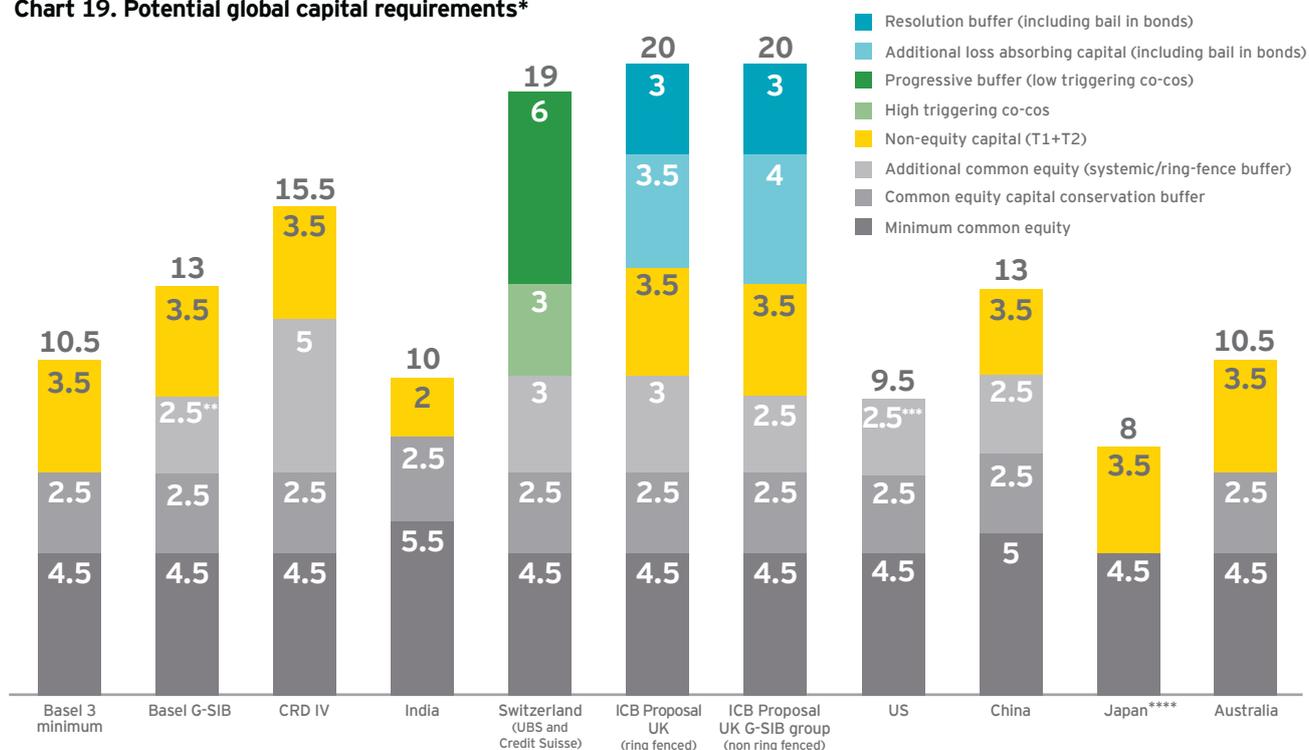
### Streamlining structures

Key considerations relate to which entities should be deposit-taking, which should be restricted to capital markets and investment banking activities, whether

the ultimate parent should be a bank or a holding company and whether to create separate operating entities to manage key operations and technology functions. Banks must also adapt to restrictions on the activities possible within foreign branches, as more regulators favor locally capitalized subsidiaries.

We have seen a number of banks embark on a review of their legal entity structures already. More are expected to follow and rationalize their portfolios, disbanding unnecessary entities to improve capital efficiency. As banks embark on this exercise, they should also incorporate a review of internal structures and hierarchies. A simpler bank should be able to remove duplicate management and de-layer the organization.

**Chart 19. Potential global capital requirements\***



\*US and other FSB member countries are working on additional bail in requirements which are likely to close the gap between Switzerland/UK and other countries in terms of going concern loss absorbancy.  
 \*\*The maximum Basel III GSIB buffer of 3.5% is not currently applicable to any institution.  
 \*\*\*US GSIB requirements are expected to be announced by the end of 2013.  
 \*\*\*\* Draft regulations for rules covering capital conservation buffer and countercyclical buffer expected in 2014/15.  
 Source: Bank for International Settlements, national regulators, EY analysis.



These reviews should also incorporate the future-state structure of the business across jurisdictions. The increasing rise of regulatory nationalism, with rules above and beyond global standards, will have a major impact on structural reform. Local regulatory requirements in individual jurisdictions have become clearer, particularly around capital levels (see chart 19) and the shift from branch to subsidiary structures. As a result, there will be a spotlight on the organization's geographic footprint to determine which locations should serve as booking centers for different products. Trapped capital and liquidity are increasing risks for global banks, as are proposed tax changes such as Europe's FTT, and we are likely to see further rationalization of where certain activities are undertaken to mitigate this issue.

### **Transforming cultures**

Banks across jurisdictions have been hit by wave upon wave of compliance failures and conduct issues. Immediate responses necessarily have been tactical as banks try to understand the scale of the problem and implement a remediation program.

There are broader issues of culture and behavior that also need to be addressed, and a number of institutions have undertaken a more strategic assessment of how their organizations need to change. Much of this focuses on risk culture, but it also incorporates broader behavioral issues throughout the business.

There is a clear requirement for the bank's risk appetite to be reflected in its culture, but organizations must also strike a balance between managing risks and delivering (sustainable) growth. Linked to that is the question of whether the organization needs to have a single culture across every part of the business or whether, instead, there are common core values but cultural variations among departments that reasonably reflect their different activities.

The major challenge for banks that have been through this process is ensuring that changes have been embedded throughout the organization and that new standards are being adhered to. Unfortunately, many lack the systems and processes required to help monitor conduct and behavior and to track how well changes are being embedded. The broader risk governance agenda will continue to be a key priority for banks, but we expect to see much more focus on this area to strengthen internal transparency and thereby reduce operational risk, particularly as it relates to conduct.

### **Connecting to shared services**

Compliance with ring-fencing and resolution planning will also require affected institutions to consider which group functions and services

should be shared across different businesses and subsidiaries, and whether some should be housed in separate operating entities. Regulators are keen to ensure that any “run the bank” operations, such as payment processing and account systems, do not suffer from the collapse of a single entity within the group.

Establishing these entities will be expensive and time-consuming, diverting funds and time away from growth-focused initiatives. As banks invest in creating these structures, it is possible that some will consider whether they might be shared by other banks. Other large competitors may be reluctant to use another bank’s operating company, but it may be a significant advantage for smaller banks due to cost savings. (See section D, below, for more on this topic.)

We also expect to see more banks introduce initiatives to transform core functions, such as finance, that may suffer from duplication and inefficiency as a result of legacy structures. Streamlining processes and controls across the bank and increasing levels of automation will form part of this and should result in significant reductions in back-office headcount.

This transformation is also likely to include a revised location strategy, as banks will be exploring offshoring and near-shoring options to benefit from lower-cost centers. However, it is vital to re-engineer the function first to avoid exporting inefficient processes to the new location. It is also important to consider how skills will be transferred between the head office and new centers, to ensure head office staff understand core processes and functions.

## Emerging markets not exempt

Banks across a number of emerging markets have embarked upon significant expansion programs in recent years, with further plans for major growth in the future. Branch networks have been extended, product ranges enhanced and staff numbers increased. Many of these institutions are recognizing the need to reform structures and key functions to manage a business that is now several orders of magnitude bigger.

Risk management will require particular focus as branch networks test operational risk capabilities, rapid growth in staff numbers affects the organization’s culture and increased demand for credit products stretches the capacity of the credit risk function. Strengthening systems, processes and oversight will be a crucial area of focus to minimize the risk of failure and provide comfort to management and investors. “Run-the-bank” technology will be a crucial investment area in the short to medium term to deliver these upgrades, as well as to ensure that the bank has the management information available to comply with local and international regulatory standards.

Other corporate functions and operating procedures will also need attention, ranging from payment processing to human resources, as these banks adapt to operating on a different scale. As more of these banks look to partnership or collaboration opportunities with foreign firms, demonstration of robust governance processes will be a prerequisite for any deal.

## D. Infrastructure: redesigned, shared

The pressure on bank infrastructure is immense. Antiquated platform and multiple legacy systems were struggling to cope before the onslaught of new demands. The spend required to deliver new systems will be significant, and with the vast majority of bank IT budgets already committed to maintenance and regulatory initiatives, there is limited scope for investment, especially in Europe (see chart 20).

Pre-GFC profitability levels had also masked the inefficiencies inherent in many bank organizations, including duplicate activities across divisions and poorly designed processes. Taking these factors together, banks will need to redesign their infrastructures to reduce complexity and meet new requirements more efficiently. And to manage costs, more organizations will explore options to outsource, to relocate and to share systems and processes with other organizations.

## Silos dismantled

Different divisions within banks have historically been guilty of re-creating rather than sharing systems, particularly if existing ones didn’t quite meet the requirements of a particular division or business line. Organizational silos and systems inherited through mergers and acquisitions have exacerbated the situation, leaving banks with complex and costly systems architectures and an army of staff to manage them.

We are already seeing a few banks develop shared systems across core functions such as finance and risk to save money. Standardization of tools, platforms and processes will need to become much more common if costs are to be brought under

“Organizational silos and systems inherited through mergers and acquisitions have exacerbated the situation, leaving banks with complex and costly systems architectures and an army of staff to manage them.”

control (see chart 6). We should also see further consolidation of processing centers, data centers and server facilities, with banks exploring outsourcing options and greater use of cloud technology.

The redesigned infrastructure should extend to a much tighter strategy for the development and support of systems and applications. Eliminating unused or underused applications will provide some cost savings, but banks should also review their broader approach to new development. Going forward, more banks are likely to configure third-party solutions instead of bespoke development in-house. We should also see consolidation of suppliers around a core group of vendors that provide both development and maintenance support.

Dismantling silos and harmonizing systems will provide banks with more reliable, consistent data across the business and enable them to harness “golden sources” of data that are easier to protect from cyber-attacks. This will support compliance with regulatory requirements, ranging from risk data aggregation to counterparty exposure. It will enable banks to benefit from organization-wide capital and liquidity management. It should also allow the organization to have a single view of customer data across channels and use more sophisticated data analytics to strengthen customer relationships and aid business development.

In other industries, particularly within the manufacturing sectors, much smaller profit margins forced the adoption of “lean

manufacturing” several years ago. Banks must consider how they can reengineer the business to industrialize more processes and make further use of straight-through processing, both to cut costs and to reduce the opportunity for errors.

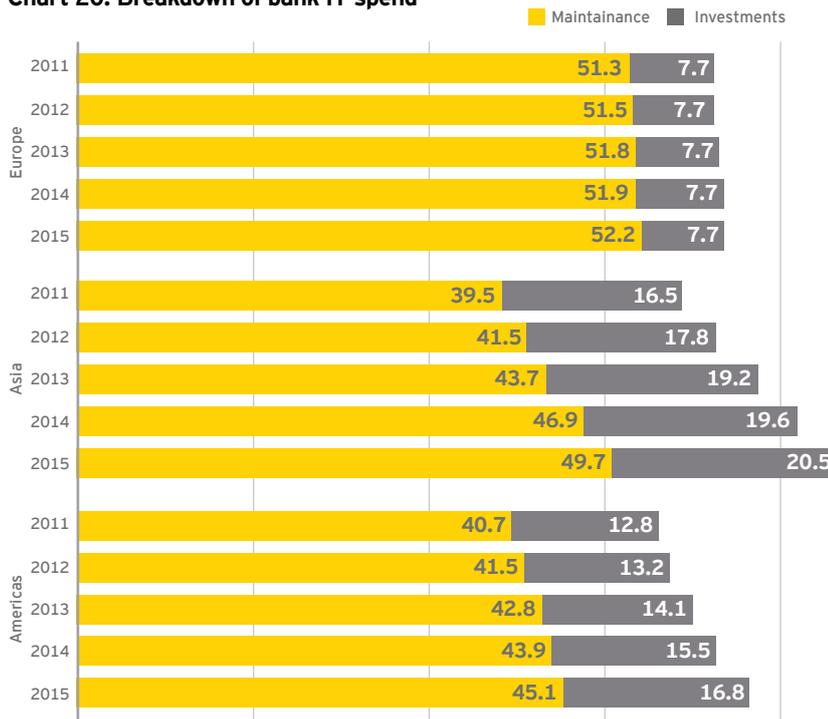
As banks review their options, the question is whether they develop solutions in splendid isolation or consider industry-wide options for sharing infrastructure. To that end, we expect more banks will overcome the aversion to sharing, both internally and externally, typified by the “not invented here” syndrome.

### Sharing is good

Although some IT systems are a source of competitive advantage for banks, many that store data for regulatory monitoring and compliance are not. Some industry-wide solutions in areas such as payments processing are well established, but we are starting to see examples of banks looking to share more back-office costs, particularly within corporate and investment banking.

One group is looking at potentially outsourcing customer compliance checks (e.g., know your customer, anti-money laundering) to a new, third-party, industry utility. Another is exploring options to create a centralized library that provides a common source of client reference data, including legal entity identifiers and background checks.

**Chart 20. Breakdown of bank IT spend**



Source: Celent, 2013

We also expect to see further progress being made within retail banking, such as potentially storing all customer account details in a central utility. Not only would this reduce costs, it would satisfy regulatory requirements for increased portability of accounts. In addition to industry-wide solutions, we expect more banks to take advantage of third parties that offer other services. There is likely to be more white-labelling and outsourcing of financial infrastructure such as payments, custody and settlements. Options to create industry utilities should also be explored by banks in emerging markets that are looking to develop new systems. In the medium term, we expect to see much less duplication of ATMs and point-of-sale machines in emerging markets.

We have seen examples of banks in Germany and Italy leveraging new technology, such as cloud computing and storage, to obviate the need for investment in physical servers and storage capabilities. Data security concerns are preventing some from adopting this innovation, but more are likely to follow as fears are allayed, possibly using a combination of public and private clouds, depending on the sensitivity of the data.

These decisions will not be taken lightly. Eliminating duplication, both within banks and across the industry, may make sense economically but the reaction of regulators to these options will be crucial. Concerns around continuity of service will need to be satisfied, as well as those related to data. But cost pressures should drive further progress in this direction. Concentration risks must also be addressed.

Some of these options would incur significant upfront development costs, but they would be cheaper than the cumulative cost of multiple institutions running similar systems. Indeed, third-party providers and industry utilities may also be more secure than

stand-alone systems at individual banks, as these services will be their primary function. The initial focus is likely to be on assessing which systems don't confer any proprietary advantage and which processes could be extracted and transferred to a third party.

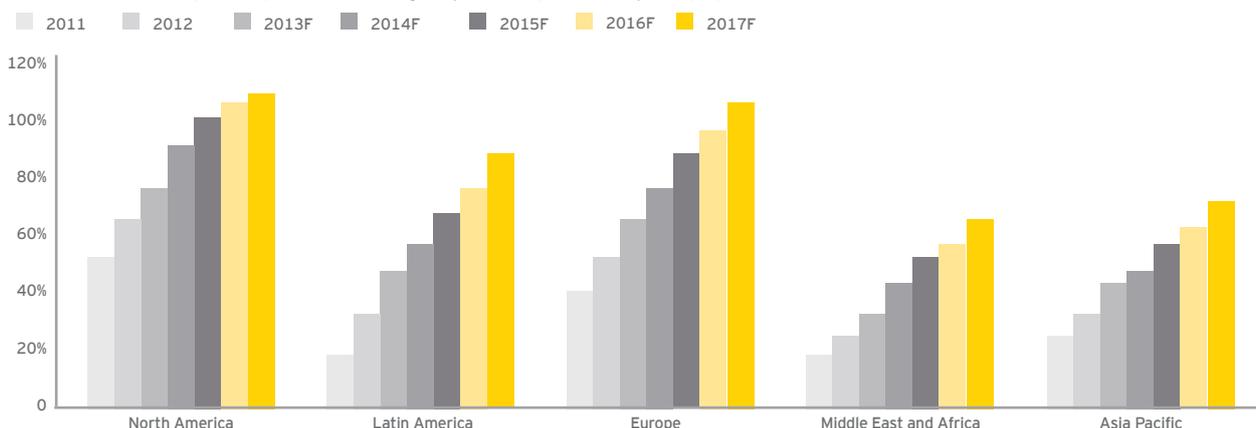
## Digital first

Given the changes in customer behavior, and the emergence of new technology, we believe banks will follow other sectors, such as media, down the path of "digital first" solution development strategies. Smartphone ownership continues to grow rapidly (see chart 21), and both retail and business customers are increasingly expressing a preference to manage certain transactions digitally instead of in-person or via a branch.

Instead of retrofitting existing solutions onto a digital platform, we expect more banks to lead with their digital solutions and make them available in branches. As customer channel preferences continue to evolve, and more customers choose to visit branches for advice on complex solutions rather than to manage simple transactions, there is also opportunity for a new branch strategy.

Banks have significant resources tied up in their physical branches and could apply lessons from the retail sector where multiple brands have "concessions" within a single department store. Sharing physical branches may not work in busy urban centers where the customer numbers justify stand-alone branches, but it could be an option in less populous locations. This is likely to form part of a broader review of, and likely consolidation of, banks' real estate footprints, particularly where they still have multiple offices in single cities.

**Chart 21. Smartphone penetration by region (as percentage of population)**



Source: Ovum, "Mobile phone and Smartphone forecast 2013-2017," May 2013.

**Final  
thoughts:  
an industry  
rehabilitated?**



There are multiple, unavoidable forces driving change, regulation being the strongest. New regulation is designed to make the industry more stable, make it less likely to require future taxpayer bailouts and ensure consumers are adequately protected.

Many of the reforms, if not all, are needed and yet expensive to implement. The impact on the cost of doing business is even more severe and regulatory constraints have rendered many current business models unprofitable. Banks need to change.

There is recognition that change is required, but banks are serving multiple masters. For regulators, stability is the primary concern. Investors may accept a lower risk-adjusted return from safer banks, but that return still needs to exceed the cost of equity. Customers expect to be treated fairly but also expect to benefit from new technology, and they are being tempted away from traditional banks by alternative, more tech-savvy providers. Banks need to innovate.

New entrants are using disruptive technologies to shake up the status quo. Many are just start-ups and their current share of the market may be small, but they are bringing to banking the sort of change we have seen in other industries. Some of these new ideas will work, some won't. Banks don't necessarily need to imitate in an attempt to compensate for not being a first mover.

They can benefit from "second mover" advantage by developing an understanding of how customers react to new propositions, adapting as needed to suit their own base. We have already seen a few

banks partner with innovators, such as P2P lenders. Acquiring innovative start-ups is also an option, but banks must be careful not to quash the creativity they're buying by "corporatizing" it.

Responses necessarily cut across business lines and extend throughout the industry. They need to restore credibility and trust. They must fix broken processes and replace antiquated systems. There is also a need to redesign compensation models as banks adapt to a lower return environment. Collectively, they should result in an industry that can generate sustainable growth and support the next phase of economic recovery in both developed and emerging markets.

Once plans are implemented, we expect banks to develop mechanisms and tools to monitor progress, particularly on the less tangible aspects of reform such as culture and behavior. Institutions will be keen to strengthen their reputations and recover profitability.

The business of banking will continue, but these responses should change the way it is conducted. Irrespective of which model banks adopt, we will see more alliances and collaborations across business lines, markets and functions as universal banking is redefined.

#### Methodology

EY maintains a database of banking key performance indicators. The database covers the top 50 banks by assets, as listed by The Banker Database at July 2013. Data is drawn from company reports. Data for revenues, costs, loan loss provisions, net interest margins, earnings per share and core tier one capital are as reported. Other figures are calculated to ensure a consistent methodology. Where no data is recorded, the reporting bank is excluded for that metric. Major outliers are also excluded to avoid distortion. Where necessary, balance sheet and income statement data have been converted to US dollars using exchange rates from OANDA (oanda.com).

The following banks were included in the analysis of investment banking revenues: Barclays, BNP Paribas, Bank of America, Citigroup, Credit Suisse, Deutsche Bank, Goldman Sachs, HSBC, JPMorgan Chase, Morgan Stanley, Nomura, Royal Bank of Scotland, Société Générale and UBS.

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