Three big bets to boost profitability and free up capital to invest in transformation

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Table of contents

04
Chapter 1

Why global banking profitability will remain a challenge in 2020

12
Chapter 2

Three common traits of high-performing banks

16
Chapter 3

How banks can strengthen resilience to boost returns

20
Chapter 4

How banks can free up capital to invest when profits are weak

23
Chapter 5

How banks can stay relevant as customer preferences change

Foreword

Banking in the new decade

Discover how three big bets can help banks free capital to invest in transformation even amid profitability pressures.

Changing times call on banks to take bold action to transform, to make the most of evolving technologies, stay ahead of new competitors and meet customer demands. But can you push forward with innovation and transformation, and improve cost efficiency at the same time? This is the dilemma for the world's banks in 2020. The imperative to transform is growing ever stronger, but profits are weak – in 2019, the sector experienced its lowest growth in a decade. The forecast for 2020 is slightly better; however, market uncertainty means profitability will remain a challenge.

Amid these challenging conditions, banks may be tempted to reverse digital transformation programs to double down on cost control, but this is a short-sighted approach that will leave incumbents behind the curve when conditions rebound. Instead, banks can learn lessons from those financial institutions that are managing to grow returns even when times are tough. Our analysis of exceptional banks – those that consistently deliver a return on equity (ROE) higher than their cost of equity – reveals that high performers focus on three key areas:

- **Resilience:** Risk mitigation is a central pillar of banking but, as the nature of risk changes, chief risk officers (CROs) must continually ensure their approach evolves too. Technology offers more effective and efficient ways to manage risks, though it also brings new ones around data security and privacy. The challenge for banks is to think differently about how to strengthen current risk mitigation efforts while also getting ahead of emerging threats, particularly those that may lead to reputational damage or financial penalties in the longer term. Effective governance models will ensure organizations build resilience, while controlling costs, and positioning for future success.
- **Cost leadership:** Chief operating officers (COOs) at high-performing banks know that how you cut is just as important as how much. Most banks have maximized the benefits of initial optimization efforts and must now think smarter. A focus on reducing marginal costs, stemming revenue leakage, and making sure every product (and client) adds to the bottom line, will be best positioned to fund investment in transformation.
- **Customer-centricity:** FinTechs and BigTechs have raised the bar for customer service, but high performing incumbents are maximizing two competitive advantages – deep customer insights and the ability to use their size to lower costs. Building on consumers' higher levels of trust in their primary financial services provider, delivering easier, more intuitive experiences and supporting customers to achieve wider goals, can help banks leverage these advantages to grow revenue.

High-performing banks show that transformation amid a downturn is not only possible but must be a priority to prepare for success in the upside. In this report, we examine the key challenges banks face and explain how emulating the traits of high performers can help boost profitability and free the capacity to invest in the next wave of digital transformation.

Chapter 1

Why global banking profitability will remain a challenge in 2020

Across regions, banks will need to focus on freeing up capital to invest in future growth.

Challenging conditions across all regions mean banks will need to focus on sustaining or boosting profitability if they are to fund investment in digital transformation.

Banks had a tough year in 2019, with weak economic results set against a backdrop of global political tensions, including US-China trade tensions and Brexit-related uncertainty.

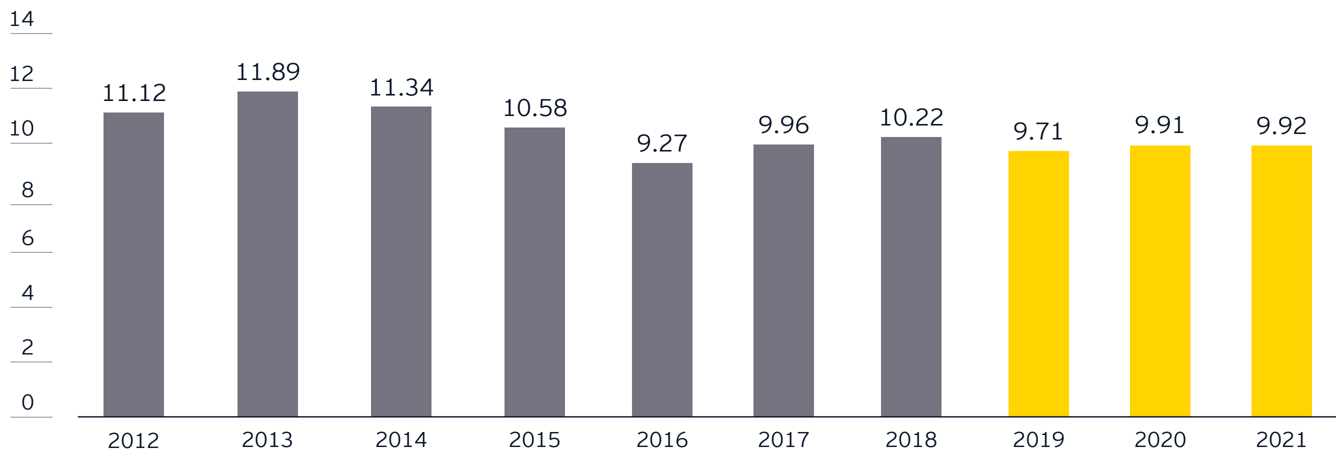
In 2020, these issues remain unresolved and even with the International Monetary Fund (IMF) forecasting a slight uptick in overall global growth, monetary loosening in both Europe and the US is likely to increase pressure on bank margins and slow revenue growth.[1] Analysts estimate that only half of the world's largest 50 banks will achieve double-digit return on equity (ROE) figures this year (see Figure 1).

Increased competition from innovative new competitors is also squeezing bank margins. These challengers are not only attracting customers, but investors too. FinTechs (and BigTechs) benefit from an absence of legacy systems, which allows them to invest in the latest technology and customer experiences, rather than just keep existing systems ticking over. And despite many challengers being in an extended cash burn phase, most report valuations significantly above book value. In contrast, bank valuations are typically below book value — the value of the entire European-listed banking sector is only slightly higher than that of Apple (see Figure 2).

[1] IMF, *World Economic Outlook Reports*, July 2019

Figure 1: Analysts expect global banks' ROEs to remain below double-digits beyond this year

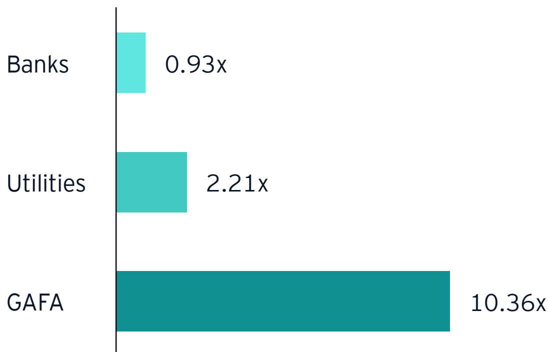
Average RoE of top-50 global banks (%)



Source: S&P Global Market Intelligence, Refinitiv Eikon, EY analysis.

Figure 2: Bank valuations remain significantly lower compared to other industries

P/B ratio by industry



Source: S&P Global Market Intelligence, EY analysis.

These utility-like ROEs are unlikely to satisfy investors for long, unless they are also accompanied by low volatility. As a result, banks must improve customer experience to sustain revenues, while at the same time, radically reduce costs. This is driving significant digital transformation initiatives. Many large banks have announced multibillion-dollar technology investments, though it is not always clear how banks expect to maximize the return on these investments.

What is certain is that the banking sector remains committed to investing in technology to transform customer experience, even in a low-growth environment. The challenge will be knowing how to free up capital to fund these investments, as different factors impact profitability and shape opportunities across the world's regions.

Europe focuses on cost control

In Europe, higher capital ratios and a significant decline in non-performing loans (NPLs) point to a healthier sector. However, the European economy remains weak. Trade tensions and Brexit-related uncertainty have contributed to anemic Gross Domestic Product (GDP) growth, with Germany and the UK narrowly avoiding recession. Further monetary easing in the Eurozone will continue to erode margins and constrain revenues, while negative rates mean deposit margins — a significant driver of revenues before the global financial crisis — are now a significant drag. In addition, the regulatory agenda in Europe continues to increase compliance costs at banks and new capital rules (i.e., Basel IV will be phased in between 2022 and 2027) might force banks to hold more capital.

Concerns about profitability, particularly at Europe's weakest banks, are driving increased discussions of consolidation across the sector. Europe is overbanked — there is one bank for every 82,000 individuals in the EU. Most are inefficient too, with numerous cost transformation programs of the past decade failing to lower efficiency ratios below 60%. The average cost-to-income ratio of European banks is 62.3%. Average ROEs remain well below the cost of equity, at less than 7%. Recent improvements in profitability have been principally driven by lower impairments rather than income growth.

However, without structural changes such as progress on the Banking Union, including the European Deposit Insurance Scheme, cross-border M&A is likely to remain low. Even if these structural impediments are addressed, any bank looking to grow (or shrink) inorganically still needs to think carefully about how they can do so in a value-accretive way. How do you grow through acquisition without destroying value? How can you exit businesses without retaining the costs of underlying systems?

With consolidation only foreseeable in the longer-term, in 2020, the focus of banks' efforts to improve profitability will be on cost reduction. In fact, without revenue growth, European banks will need to cut almost one fourth of their cost base to achieve the industry's typical ROE target of 12%. Achieving this will require firms to look beyond traditional cost-cutting approaches to radical transformation that includes extensive use of managed services, or industry utilities, to take on critical but non-core activities in a more cost-effective manner. Scaling back and reconfiguring branch networks is also required, alongside increased automation, simplification of products, services, and underlying processes and use of partnerships to build scale. With such challenging fundamentals, the difficulty for banks will be deciding how to free up capital to invest in this transformational agenda.

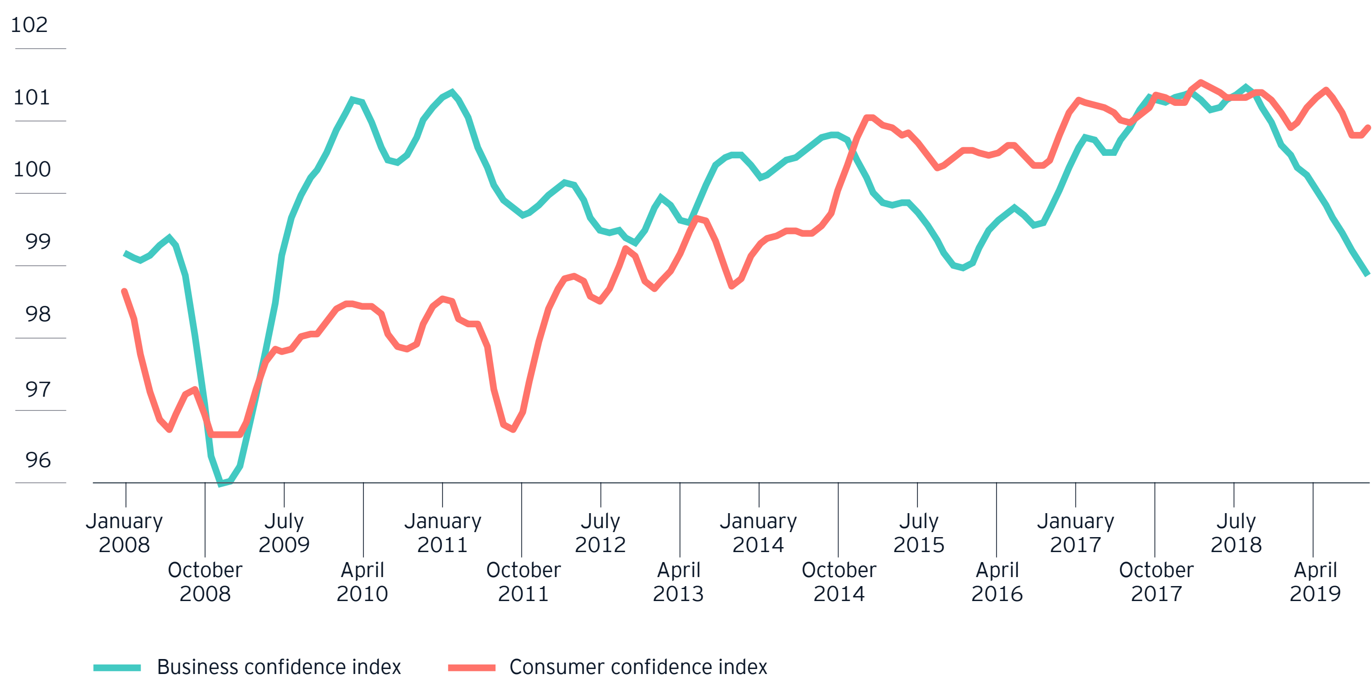
US war for talent amid technology transformation

In the US, the banking sector continues to deliver double-digit returns, putting US banks in a comparative position of strength. A bounce back in financial markets drove record performances for a number of institutions, but can this be maintained? Market fundamentals remain positive; while there has been a decline in business confidence, consumer confidence – the core driver of the US economy – remains robust (see Figure 3).

This may drive differentiated performance across the commercial and consumer banking segments, but even in consumer banking, risks remain. Estimates suggest that about one-third of US workers are freelancers or part of the gig economy. With such a large part of the workforce in precarious work, should consumption slow or companies cut costs by reducing staffing levels, greater unemployment is likely to see some customers struggle to service their debt and lead to a rise in banks' NPLs. This means US banks too will seek efficiency gains to sustain profitability and support a digital transformation agenda.

Still, the underlying resilience of the US banking sector means that even if performance weakens, banks have a greater capacity to continue investing in technology and digital transformation, to both improve customer experience and cut costs. This agenda will continue to drive branch closures, reflecting customers' growing preference for digital banking channels, and M&A activity. The US market is even more overbanked than Europe, and not all banks will be able to make the investment in the digital agenda that customers are demanding (see Figure 4).

Figure 3: US consumer confidence remains strong, even as business confidence has declined

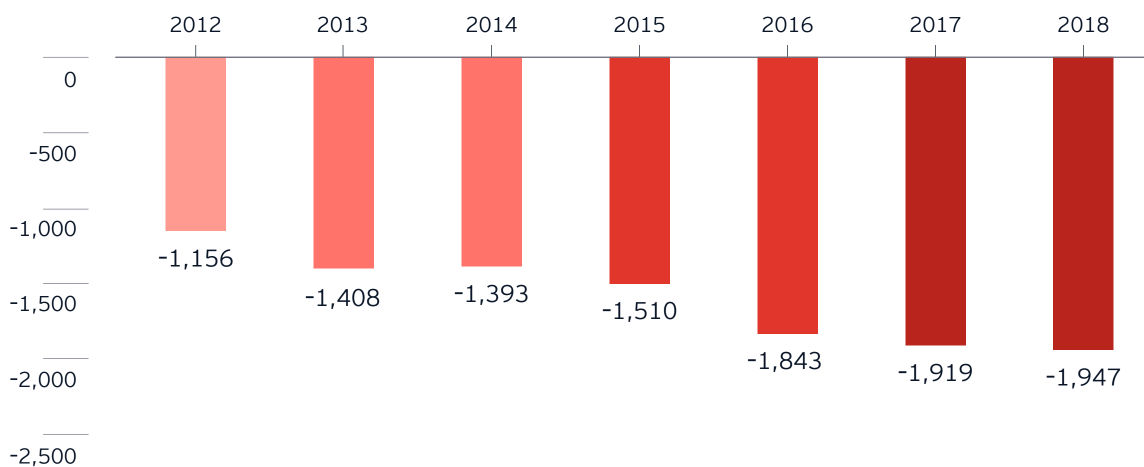


* Numbers above 100 suggest an increased confidence in near future business performance, and numbers below 100 indicate pessimism towards future performance.

Source: OECD (2019), Business confidence index (BCI) (indicator). doi: 10.1787/3092dc4f-en (Accessed on 02 December 2019), OECD (2019), Consumer confidence index (CCI) (indicator). doi: 10.1787/46434d78-en (Accessed on 02 December 2019).

Figure 4: Branch closures have increased significantly in the US as customers continue to prefer more digital engagement

Branch net closings by banks and thrifts since 2012



Data complied 7 January 2019.
Analysis is limited to banks and thrifts that opened and closed branches between 1 January 2012 and 31 December 2018.
Net closing reflects the differences between branch openings and closings.
Branch opening and closing are limited to cases where openings and closing dates are available.
Branch data collected on best-effort basis.
Excludes credit union branches.

Source: S&P Global Market Intelligence.

Some estimates suggest that investment in technology could see up to 200,000 job cuts in the industry over the next decade.[2] But while banks may reduce headcount in certain areas, the deployment of new technologies requires bank employees to develop new skills. Here we anticipate challenges.

Banks universally acknowledge they need to hire individuals with a greater understanding of new technologies, but struggle to do so. While banks remain a popular employer for business graduates, no traditional bank features in the top 30 most attractive firms for engineers, and just two do for computer science graduates.[3] Competing for leading talent with global technology companies as well as a handful of global banks is likely to leave most US banks facing a chronic staff shortage to support their digitization initiatives. Staff recruitment and retention to support digital transformation is set to become a new battleground for the sector.

[2] Wells Fargo, *Banking on Tech*, September 2019

[3] https://universumglobal.com/blog/us-most-attractive-employers-2019/

Asia-Pacific competition drives investment in digital transformation

Banks in the Asia-Pacific region will not escape margin pressure. In 2019, we observed interest rate cuts at several central banks, including those in India, Australia and Hong Kong, which is experiencing an economic contraction and budget deficit for the first time in over a decade. Many Asian economies are manufacturing exporters, and a slowdown and weakened demand in Europe or the US will flow through to these markets, increasing the rate of non-performing loans and associated impairment charges.

However, banks in most Asia-Pacific markets are in a strong position to manage these risks. They are generally well-capitalized, and while average ROEs have consistently fallen since the global financial crisis, they remain in double digits. Efficiency ratios are significantly better than those in the US or Europe (see Figure 5).

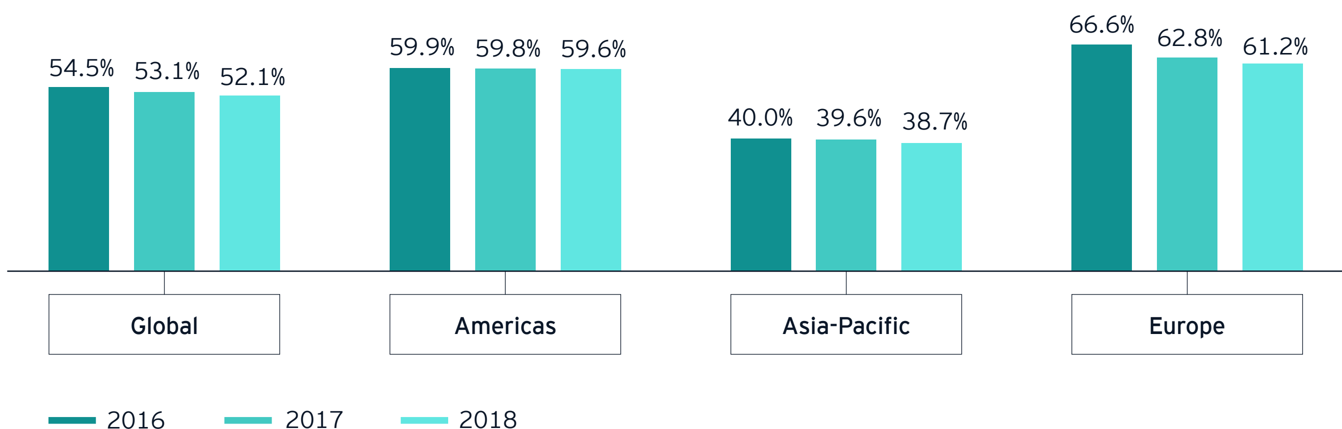
Of greater concern is the risk that new competitors pose to incumbents. Asia-Pacific is home to successful BigTech banking competitors, a thriving FinTech scene and leading digibanks. Open banking agendas across the region, whether regulatory driven as in Australia, or more organic as in China, will encourage competition.

Liberalization in China is also likely to change the competitive dynamic in the region. For years, the country's financial markets have been largely closed to foreign financial institutions, but this looks set to change in the wake of reforms to standardize market entry rules and remove ambiguity around foreign FIs' entry policies.

These competitive dynamics mean banks in the region will need to continue investing in building digital banking capabilities to further drive efficiency and productivity and enable them to better serve customers as effectively as possible, particularly across markets. Doing this successfully will help banks reach more customers, especially unbanked and underbanked individuals and micro, small- and medium-sized enterprises, which we estimate could generate an additional US$800b in revenues across Asia-Pacific.

Figure 5: Asia-Pacific banks continue to outperform other regions on efficiency parameters

Average efficiency ratio by region



Note: Weighted average cost-income ration for top global banks in terms of asset size (2018).

Source: S&P Global Market Intelligence, EY analysis.

Uncertainty shouldn't delay transformation

The groundwork laid over the past decade means most banks are relatively well-prepared to manage through current market challenges, even if conditions worsen. *The tenth annual EY/International Institute of Finance (IIF) global bank risk management survey* found bank executives are relatively sanguine about their ability to weather a downturn, perhaps because mechanisms are now in place to help them adapt to shifts in external conditions. This flexibility, if real, will prove important should the market deteriorate (see Figure 6).

However, even if the economy doesn't worsen – 74% of banking executives anticipate continued economic growth over the next year – many banks still face a mammoth task to deliver double-digit returns. Without revenue growth, the world's largest 200 banks must cut more than US$200b (15%) from their combined cost base to achieve an average ROE of 12%.

In 2020, we see banks focusing their agendas on streamlining businesses and better serving customers. Against this backdrop, banks need a strong control infrastructure to manage change, but also to invest heavily in technology.

Many banks have announced significant technology budgets, although it is often unclear how much of this investment is directed to maintaining legacy systems or an innovative and transformative agenda. It is also uncertain what the ROI of spend on innovation is, and how those initiatives are aligned to organizations' core strategies.

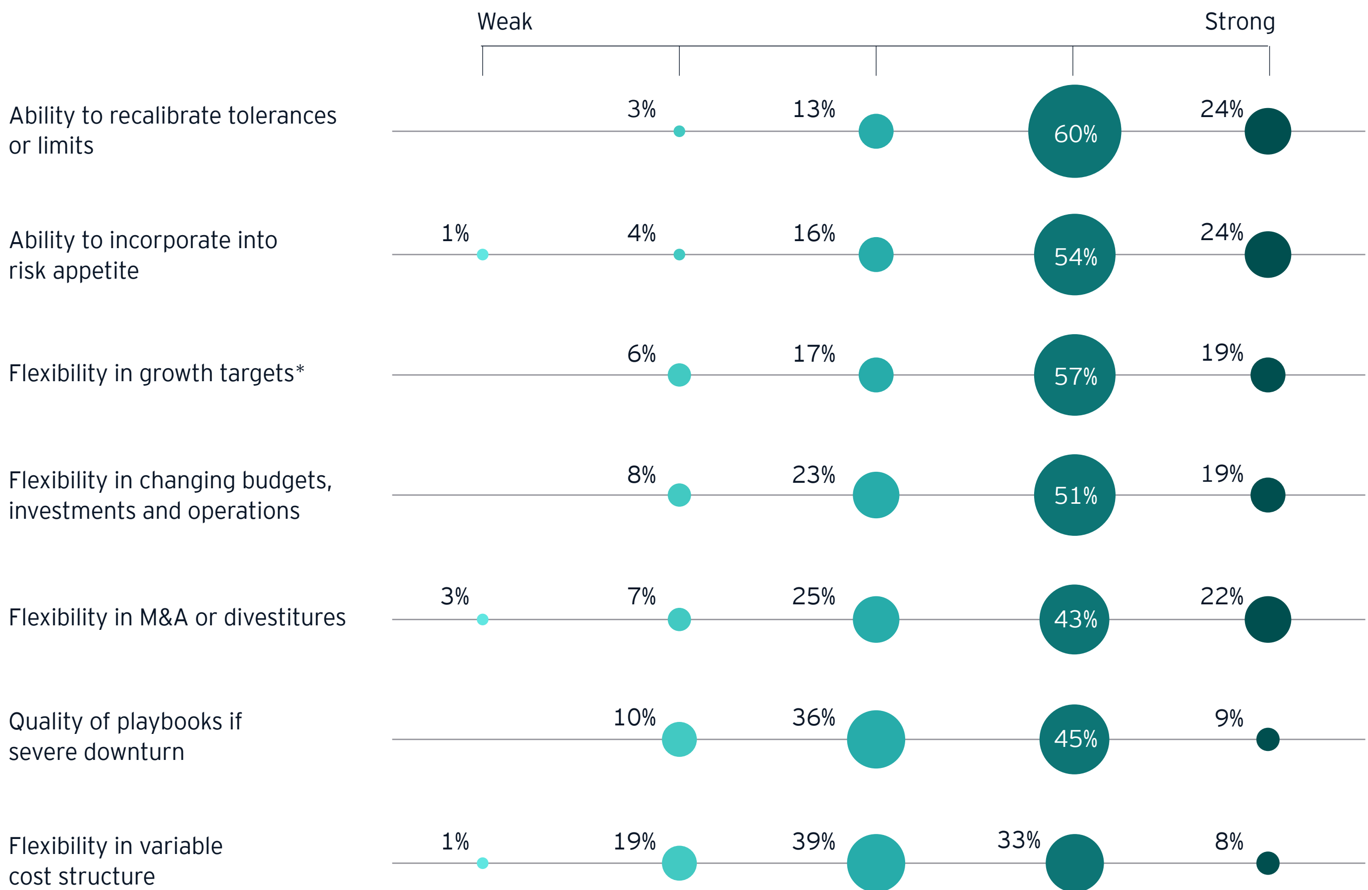
For banks, the ability to continue to invest in digital transformation will depend on efforts now to improve profitability. Banks can learn lessons from peers that have consistently outperformed through driving efficiency, strengthening resilience, and creating a customer-centric culture.

US$200b

cost reduction required for the world's largest 200 banks to achieve 12% ROE

Source: EY analysis, S&P Global Market Intelligence

Figure 6: Banks are better placed today to manage an economic downturn



* By portfolio and market or client.

Source: Tenth annual EY/ International Institute of Finance (IIF) global bank risk management survey.

Chapter 2

Three common traits of high-performing banks

The highest performing global banks focus on resilience, commit to cost reduction and put the customer at the heart of everything.

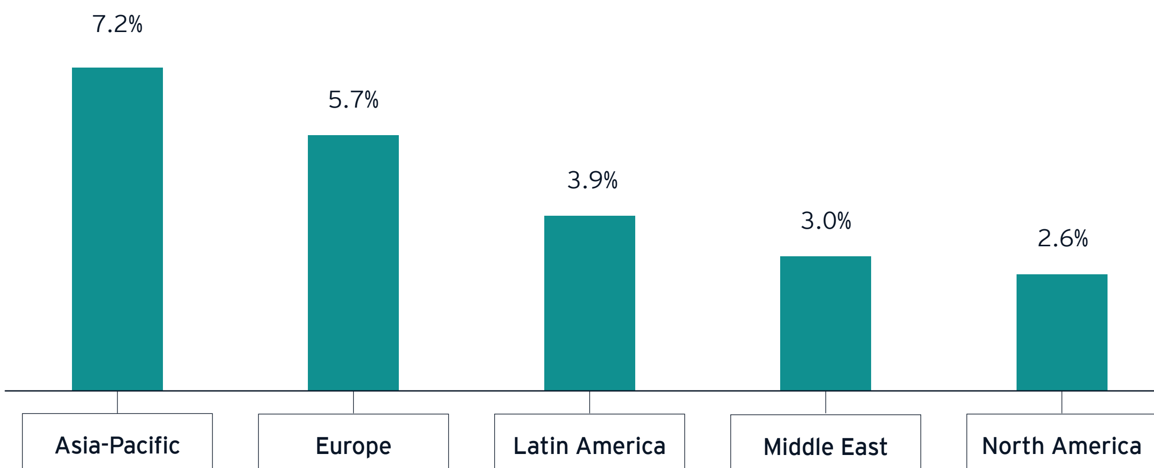
Amid weak profitability, some banks are still reporting strong growth. What's the secret of high performers — and how can other banks emulate their success? Focusing on adopting three common traits can help banks boost revenues and enable investment in transformation.

In 2019, banks faced the weakest global economic growth in a decade and analysts expect little uptick in 2020. Amid challenging market conditions, profitability is under pressure, but some organizations are still finding paths to growth.

The annual EY analysis of the world's largest 1,250 banks has found that 350 have consistently delivered ROEs above their cost of equity over the past five years. The success of these banks, which operate across diverse markets, suggests the sector shouldn't accept low profitability as the new normal, but instead understand and emulate top performers (see Figure 7).

Figure 7: Consistent outperformers maintain a strong profitability differential compared to their peers

Outperformers' average five-year profitability delta (ROE — Cost of Equity) by location



Source: EY Analysis

Higher performers have strong core: focus on risk, customer and cost

The EY analysis of these exceptional banks reviews their performance through a sophisticated lens that adjusts for external factors to identify those fundamental capabilities that are common across high performers.

The first of these capabilities is a clear strategy based around a clear core competence. For a small bank, this may mean focusing on a niche segment. For a large bank, this may mean the ability to deliver a blend of capabilities efficiently to a wide client group.

Exceptional banks understand their role in the financial ecosystem, allowing them to create value in highly specific ways. These banks continually improve their approach to value-creation, through a laser-like focus on what they do best. They double-down on their strengths — investing to build up key capabilities that differentiate them from competitors — and consider how to partner with others in the ecosystem to complement weaknesses or provide new products and services. They know what they do well, and they don't stray from that path.

Banks yet to define their clear competence should understand that building this vision and a plan to achieve are priority actions, but ones that take significant time to achieve. In the meantime, three other shared traits can be adopted more quickly, to help banks ride the wave of uncertainty, lift profits and free investment for transformation (see complete methodology at end of chapter 2).

1. Outperformers build resilience

Success comes from a position of strength. High performers take a comprehensive approach to risk mitigation to protect the business and boost returns. They are proactive about tightening prudential credit risk management and continually assess assets to reduce risk and bolster capital strength.

Outstanding banks know how to harness the power of technology and data innovation to make better decisions about risk — or partner with those that do. And they are constantly on alert to new risks, particularly those that may damage their reputation. For example, one Norwegian bank has worked to reduce its exposure to cyclical industries — including oil and gas, and shipping — and focus on other industries to grow profits.

2. Outperformers control costs

The best banks have highly efficient processes. As most are large with sizable networks, this kind of efficiency can only result from an organizational mindset that empowers individual employees to make the right decisions without explicit guidance from management. In short, the entire organization must come together.

Outperformers typically have a mindset of continuous improvement, constantly assessing their cost base. They also display an agility which enables them to quickly respond to shifts in the market.

One high-performing Mexican banking group has supercharged its efficiency by doing away with branches and instead offering specialized lending services (mostly to government entities) via business centers.

3. Outperformers are customer centric

Many outperforming banks identify a clear customer segment and plan their entire strategy around understanding and meeting the needs of these target customers. Virtually every significant decision is geared to this goal — from developing and marketing products, allocating investments in capital and ensuring that all management behavior is driven by a focus on the customer.

Outperformers focus on developing high-quality, hyper-relevant services and experiences for target customers, rather than pushing products through traditional sales and markets.

Outperformers focus on developing high-quality, hyper-relevant services and experiences for target customers, rather than pushing products through traditional sales and markets. They continuously explore and create new offerings that better meet the needs of customers, regularly assessing service quality to ensure exceptional client experiences and drive retention.

One Danish bank rewarded customers with strong credit with a new loan structure, which was more attractive than traditional mortgage loans. The product helped the bank make up for the loss in fee income and falling interest income in traditional products. From 2013 to 2016, the bank issued US$9.3b in new home loans, while its traditional loan portfolio contracted.

Adopting your own high-performance culture

These attributes may seem fundamental, but the truth is they are poorly embedded in most banks. Even those that do seek to apply them, don't do very well, sometimes because of efforts to adopt all three. In our experience, even high-performing banks focus on a maximum of two of these three capabilities in their business. The first challenge for banks seeking to emulate these top performers may be to determine which of their trait(s) they should adopt, in their own organization, recognizing that if they try to do them all, they will fail.

Next, leadership teams must establish the governance and culture which supports this common vision, agree on the behaviors required to achieve it, and strive to execute against them. High performers are guided by long-term strategic plans, rather than switching back and forth in response to fast-moving market trends. These plans include a clear destination 10 years out and the interim measures and initiatives required to get there.

Making short-term gains to reap long-term benefits

But while it's clear these behaviors drive long-term success, the reality may be different for those banks operating without a long-term strategic plan in a challenging market. These organizations need a short-term plan for 2020 that prepares them for this strategic shift — in essence, managing through "now" to prepare to meet the "next" and be ready for "beyond." And while it may seem that the easiest way to improve profitability is to cut costs by reducing investment in transformation programs, this is not the best approach. Instead, banks should consider what action taken now will reap both immediate and longer-term benefits.

For example, while a bank cannot redefine its core competency overnight, it can mitigate risks and strengthen resilience. A culture of continuous cost reduction takes time to nurture, but action can be taken now to free up investment in organizational transformation. Customer-centricity requires banks to invest in developing an agile mindset, but incumbents can leverage their significant advantage as trusted custodians of people's money and data to strengthen client relationships. Organizations that work over the coming 12 to 18 months to do this will be well-positioned to drive sustained outperformance in the longer term.

Methodology

The challenge of identifying the world's leading banks is that they have different business models and operating environments. If an Indian bank delivers better returns than an Italian bank, you can't assume the former is better. The cost of capital of each bank may be radically different, the levels of competition in each market may vary and an array of macro factors external to the organizations themselves may also influence performance.

The EY professionals have developed a methodology to identify outperforming organizations by adjusting for these external factors and, importantly, identifying the fundamental capabilities of these firms that have led to outperformance:

Step 1 We looked at more than 1,250 banks to identify those that were able to consistently deliver returns on equity that were greater than their cost of equity.

Step 2 We identified where banking performance was principally driven by structural factors (including macro elements, such as GDP growth and banking penetration, along with industry factors such as margins, risk, and competition) to ensure the exceptional performers were not simply banks that benefited from a favorable environment.

Step 3 We determined the key reason for these banks' success — growth, efficiency, risk or capital management — to identify which areas of the business they were focused on to drive performance.

Step 4 We undertook a qualitative analysis of each of these banks to understand the capabilities that underpinned outperformance.

Chapter 3

How banks can strengthen resilience to boost returns

Banks that better manage risks can boost returns amid profit pressures. Four areas of focus can help chief risk officers (CROs) build resilience.

High-performing banks know that success comes from a position of strength. CROs that reassess their approach to mitigating current risks — and prepare for future threats — can help build the foundations for revenue growth, even in uncertain times.

High achievers are those with a clear core competence, according to an EY analysis of outperforming banks. But while resetting strategy or redefining value propositions takes time, there are faster ways to create advantage, including mitigating risks to strengthen resilience and allow banks to invest in wider transformation. In turbulent times, when banks are undergoing reorganization and change that is putting the organization under strain, a strong controls infrastructure is critical.

In the 2020 operating environment, CROs balance a multitude of risks, with geopolitical and credit risk among the biggest, according to a recent Bank of England survey.[4] With all signs pointing to a challenging 2020 for banks, the focus for CROs will be tactical risk management, including enhancing underwriting standards in structurally weak markets and building additional data metrics to assess customers in high growth areas.

They must also manage a range of other risks including third-party risk management, customer data privacy at partner institutions, and cyber-attacks which are difficult to control and prepare for, but which can cause serious reputational damage. Helping banks avoid one-off expenses — which may impact banks' ability to invest in those initiatives most likely to boost long-term profitability — will be a critical aspect of a CRO's role.

With this in mind, CROs must ensure their approach to risk mitigation is best positioned to boost returns.

[4]Systemic Risk Survey, Bank of England, 2019 H1 survey results.

Four key areas of focus can help:

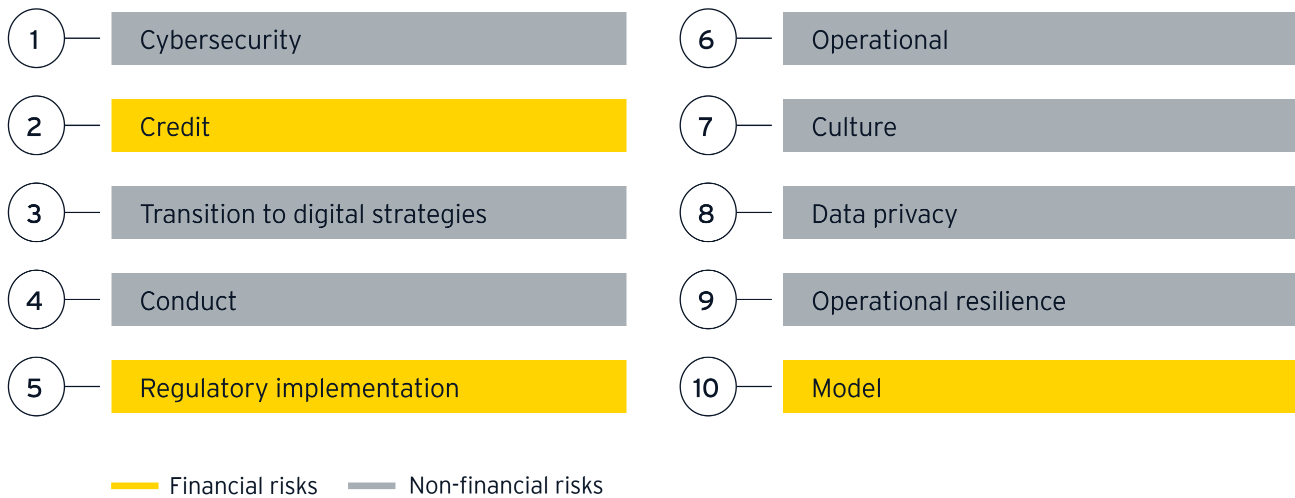
1. Better risk modeling and balance sheet management

The recent EY/IIF survey found that credit is the second most significant risk for CROs. With this in mind, prudent provisioning will be central to banks' ability to invest in the wider transformation agenda (see Figure 8).

Many banks are already taking action, reducing future provisions by employing prudential credit risk management, tightening prudential calculation rules, de-risking loan portfolios and focusing on customer due diligence. Other tactics to improve credit quality include divesting high-risk businesses and reallocating capital to high-return business segments.

We see some organizations seeking to improve asset quality by selling non-core equity holdings, reducing risk-weighted assets and shrinking the balance sheet to improve capital strength. Enhancing capital efficiency by implementing minimum profitability thresholds and faster asset rotation will also be a key pillar of balance sheet management.

Figure 8: CRO's top risk priorities over the next 12 months



Source: Tenth annual EY/IIF global bank risk management survey.

2. Harnessing technology and data innovation

Big data, analytics, machine learning and cognitive computing can be powerful tools that help banks digitalize risk management operations and introduce new approaches to risk modeling that together reduce costs and strengthen balance sheets.

For example, analytics-based risk assessment can optimize asset and liability composition, allowing banks to better structure their balance sheets to support profitability. Analytics can also improve fraud detection, credit quality insight and anticipate problems among customer segments and within business lines. They can also enhance the analysis of credit risk by giving insights into which products and services should be offered to different client segments, limiting banks' credit exposure in a downturn and preventing Basel IV risks, preventing capital dilution in the event of a recession.

Analytics can also be used to support the development of downturn scenario models, including loan portfolio contraction and expansion, evaluation and monitoring of default rates, and risk appetite modeling. In partnership with machine learning, analytics are also used by high performers to better assess money laundering risks. And many banks are broadening their use of biometrics and natural language processing to verify identities, and using cognitive computing to improve transaction monitoring and investigation.

Analytics can also improve fraud detection, credit quality insight and anticipate problems among customer segments and within business lines.

3. Partnering to reduce risks and costs

But in many cases the application of new technologies is in parts of the business that are critical and yet non-differentiating – for example, in know-your-customer (KYC) or financial crime detection. Partnering with a managed services provider in these areas, as well as tax, financial and legal services, can be a more cost-effective option that enables banks to realize the radical cost reduction required to hit ROE targets.

Managed services providers with the right mix of technology investment, and the talent and processes to deploy them, can typically generate a greater ROI than a bank trying to invest across all its non-core functions. And, critically, banks can free up their own resources to focus on creating the strategic opportunities that will add value and grow revenue.

4. Being alert to new risks, especially reputational threats

While the transition to automation and digitalization creates opportunities to mitigate many forms of risk, it also introduces new ones. Many of these emerging risks are likely to be subject to increased regulatory action, but CROs should act now to secure banks against potential reputational risks:

- **Third-party risk** could rise as use of managed services and utilities increases. Banks must rationalize their vendor list, introduce robust vendor management and enable the ability to identify third-party risk and satisfy regulators of their operational resilience.
- **Data risk** is a growing threat as open banking sees customer data handled by more parties as it is transferred between banks, their competitors and non-banks. This highlights the requirement for banks to facilitate the transparent and ethical use of customer data or risk reputational damage.

- **Systemic risk** is increasing as more banks adopt cloud services as they decentralize technology stacks. Many banks are dependent on the same few providers, with more than two-thirds of the market share going to the top four entities.

  Additionally, those providers are typically based outside bank's headquartered jurisdictions.
- **Talent risk** as banks face a shortage of skills needed to deploy new technologies across the organization. Attracting talent is less of a challenge than in the immediate aftermath of the crisis, but banks must still seek to mitigate this risk through upskilling existing staff; for example, through partnerships with universities and other third-party training organizations.
- **Responsible banking principles** are moving center stage, as investors look for reassurance that organizations are doing the right thing by their clients and the planet. Financial inclusion is one area of focus, as is climate change, with a significant proportion of banks' lending books exposed to climate-related risk through their clients. The EY/IIF survey found that four in five (79%) banks have incorporated climate change into their risk management approach. A successful approach for banks will focus less on the ultimate exposure and more on initiatives that have helped clients go green and create sustainable business models.

Resilience lays the groundwork for radical transformation

In many ways, the story of banking over the last decade has been dominated by the misjudgment of risk, whether in the drag of non-performing loans in some European markets or the huge fines for conduct breaches that have destroyed profits. The focus of CROs in 2020 must be on strengthening the approach to current risks in the near term, but also preparing to get ahead of emerging threats, particularly those that may lead to reputational damage or financial penalties in the longer term. With many banks preparing for radical transformation in coming years, effective governance models will ensure organizations build resilience, while controlling costs, and positioning for future success.

Chapter 4

How banks can free up capital to invest when profits are weak

In 2020, banks will face the twin challenges of cutting and investing in transformation. Four areas of focus can help chief operating officers (COOs) do both.

COOs at high-performing banks know that how you cut is just as important as how much. In 2020, banks that focus on reducing marginal costs, stemming revenue leakage, and making sure every product (and client) adds to the bottom line, will be best positioned to fund investment in transformation.

The EY annual analysis of the world's top top-performing banks — those that consistently deliver ROEs above their cost of equity — reveals that high achievers know the importance of cost leadership.

Between 2016 and 2018, the largest 200 banks globally reduced their cost base by approximately 5% on an inflation-adjusted basis. Most of these savings came from low-hanging cost optimization opportunities, which are now maximized.

But, costs continue to rise faster than revenues and achieving further efficiency gains will be difficult in 2020, which analysts predict to be a challenging year for banks. COOs must think differently about how to rapidly cut costs to both boost profitability and free up investment for the next wave of digital transformation.

Four areas of focus can help guide efforts:

1. Focus on marginal costs

Why do banks that have long focused on cost reduction still invest heavily in non-strategic areas, such as KYC, legal and financial crime?

For most banks, it's because cost indicators are set against budget outlays; and cost reduction targets are set against parts of the business with the biggest budgets, rather than focusing on productivity. This means banks continue to own these noncore and non-value-adding activities, which add to the overall complexity of the organization. In essence, banks typically focus on reducing 4% of 50% of the cost base, rather than 90% of 4% of the cost base.

Instead, banks must build a clear view of what's value accretive, and what isn't; and the basis for that should not just be the budget required for the activity. Simply because an activity is less costly does not mean it creates more value. For banks to identify the right value accretive activities, they need to strike a balance between rationalizing the denominator (input cost) and optimizing the numerator (output value).

The core elements of driving a value focus will include defining the right metrics, developing measurement frameworks to identify and assess the potential value and cost of opportunities and establishing strategies to deliver on opportunities.

But, doing this can be challenging. While a benefits case may seem clear, the implicit impact on the organization may not be, due to a lack of adequate metrics and frameworks. Building this understanding requires banks to consider all dimensions together, including financial resources, physical assets, data and people. It requires more granular data on additional costs (both direct and indirect) attributed to the growth opportunity. It also requires an understanding of the existing operations of the banks and additional complexity that an opportunity or investment could bring.

Banks that do this well make it an ongoing priority. One leading Taiwanese bank has set up a designated unit focused on continually re-examining operations to find opportunities to improve and streamline.

> "COOs must think differently about how to rapidly cut costs to both boost profitability and free up investment for the next wave of digital transformation.

2. Reassess non-strategic activities

Outperformers rapidly reduce costs to create capacity to innovate, even in challenging market conditions. Many do this through outsourcing, use of an industry utility or managed services, which can be a more effective and value-adding way to run non-core but critical activities. Another option is moving non-value adding products and services to third-party vendors or automating them, cutting unprofitable products or collaborating with specialist providers to deliver those services that are critical to your client, but which you can't deliver profitably.

For example, investment banking divisions can free up capital by automating manual processes within post-trade, reducing siloed collateral management, and leveraging the right partners to improve strong data quality and reduce inconsistent trade representations and overall business risk.

3. Stop the leaks

The more complex an organization's processes, the more likely it is that revenue is leaked. This can occur particularly post-merger, after frequent system changes, and complex integration processes. Within retail banking, we see leakages across the product set, but especially in areas such as current accounts, credit cards and consumer credit or with bundled products, where fees are not consistently charged. These leaks can be small at an individual level, but add up to a significant loss – we've seen banks lift their revenues by double-digits just by applying rules correctly.

Beyond stemming the leaks, banks must ensure that every product set and every client is adding to the bottom line to maximize revenue generation.

4. Prioritize legacy system challenges ahead of new innovation

Banks cannot maximize returns on their investment in digital channels without first addressing challenges around legacy accounting and booking systems, data reconciliation, and a common view of the customer. These challenges include an inability to run in real-time, which stymies the development of the new services and experiences customers demand. Nearly 50% of banks do not upgrade old IT systems as soon as they should, according to a recent report by the UK's Financial Conduct Authority.[5]

Once the legacy issues are addressed, only then the industry can adopt a more agile approach and lean thinking for investment allocations and have a DevOps approach to implementation. To achieve this level of agility, decisions need to be made quickly and the level of bureaucracy and ideation to implementation and delivery timelines should come down. Other drivers which will enable agile decision-making are the simplicity of the organization and strong internal technology.

Today, most banks are better prepared than they were a few years ago to build a simpler, agile and future-ready organization, but need to create capacity to continue to invest in transformation initiatives. Fixing these key issues first will lay the groundwork for later investment in innovation and create a more effective and resilient organization in the long-term.

Invest now to prepare for the upswing

Creating capacity to invest will be critical for banks in a challenging operating environment. If profitability declines, the investment that can be committed to transformation initiatives will be limited, placing an institution at a disadvantage to competitors. Catching up is likely to be costly. Those that emulate high-performing banks to drive new efficiency measures now can free up the capital that allows for investment in transformation at the bottom of the cycle – ensuring they are well-positioned for success in an upswing.

[5] Cyber and Technology Resilience: Themes from cross-sector survey 2017–18, Financial Conduct Authority, November 2018.

Chapter 5

How banks can stay relevant as customer preferences change

Customer-centric banks outperform their peers. Three areas of focus can help deliver the outstanding experiences consumers expect.

FinTechs and BigTechs have raised the bar for customer service, but high-performing incumbents are maximizing two competitive advantages — deep customer insights and the ability to use their size to lower costs. Building on consumers' higher levels of trust in their primary financial services provider, delivering easier, more intuitive experiences and supporting customers to achieve wider goals, can help banks leverage these advantages to grow revenue.

As banks head into a new decade, analysts forecast that profitability will remain a challenge. Given this challenge, do banks double down on cost control or commit to driving transformation? High-performing banks know that both are key to lifting profitability and that a focus on the customer is a smart place to start.

Competition has raised the bar for customer satisfaction

For banks, the challenge to keep up with changing customer expectations is not new, but it is increasing. Advancing technology and reforms, such as open banking, have expanded the financial options on offers and customers are turning to a broader range of providers to address their needs.

For example, small and medium enterprises (SMEs), frustrated with banks' stringent underwriting criteria, poor customer service and slow credit application processes and decisions, are increasingly switching to FinTechs. FinTech adoption among SMEs has grown to 25% and could surge to 64%, based on current trends. Meanwhile, recent announcements of BigTech and bank partnerships look set to bring a new level of customer service to financial services, and seem to contradict frequent arguments that tech giants don't really want to get into banking.

The good news is that our analysis of the world's top performing banks — those that deliver an ROE above their cost of equity — shows that many high performers are using a customer focus to get ahead. They are making the most of two fundamental advantages in the fight against new competition: experience of managing customers' assets through the business cycle; and the right data and tools that allow for the greatest insight into each customer. Most FinTechs and BigTechs lack both. Banks also can leverage their large balance sheets, strong capital adequacy and experience to lower the cost of service. Estimates suggest that large UK banks can price a mortgage 30bps cheaper than new competitors, just as a result of their internal ratings-based credit models.[6]

With this in mind, incumbents must build the seamless, easy experiences customers expect, while protecting their reputation as trusted protectors of customer data and remaining price competitive.

Balancing these priorities will be a challenge, but three areas of focus, that play on banks' inherent advantages, will help:

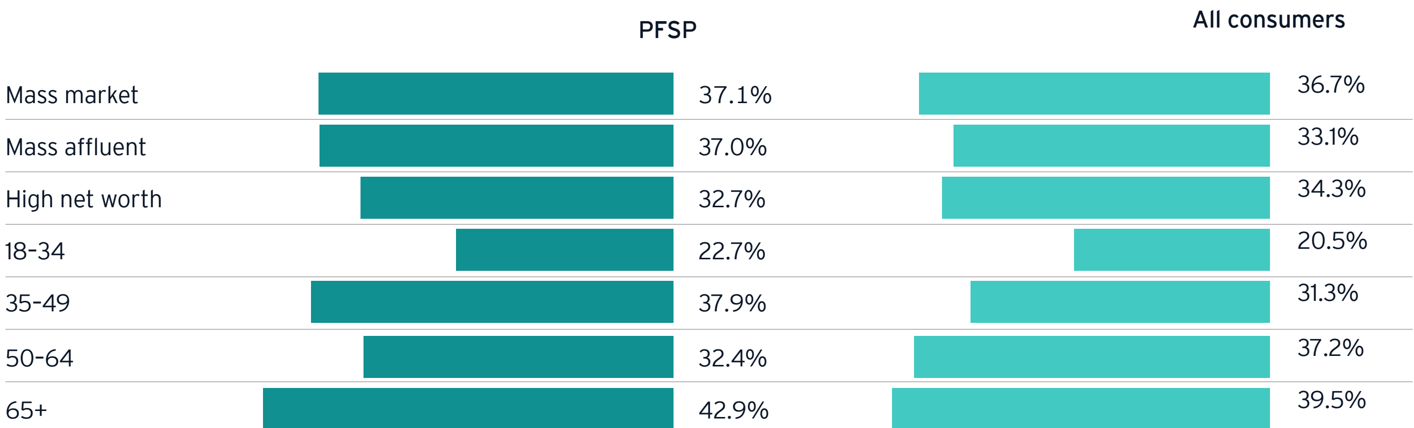
1. Play the trust card

Despite trust in the overall financial sector declining, customers still hold high levels of trust in their primary financial service provider (PFSP), according to EY NextWave Consumer Financial Services research. Sixty percent of consumers surveyed said they are comfortable sharing personal information with their PFSP without specific assurances about data protection and security.

Capitalizing on this trust advantage can help banks, not only gain competitive advantage, but also drive revenue growth. To understand the impact of trust on consumer demand, we ran a simulation that varied the trust features of different banking offerings, while keeping all other variables the same. Examples of "trust features" include full price transparency, hyper-personalization and the ability to own and control the use of one's personal financial data (similar to what is mandated by General Data Protection Regulation or GDPR).

[6]https://bankunderground.co.uk/2017/03/13/unintended-consequences-specialising-in-risky-mortgages-under-basel-ii/

Figure 9: Incremental share of preference earned by offering a holistic trust bundle



Source: EY NextWave Consumer Financial Services: financial subscriptions are coming.

We compared the share of preference scores of the those offerings with a "trust bundle" against the base case of current offerings for banks, and we found a clear advantage for those with features that built trust with customers. This advantage translates to a significant revenue opportunity — within the US alone, we estimate that strengthening trust could help banks create an additional US$11.3t in assets (see Figure 9).

These results point to some clear short-term actions for banks:

- **Enhance data security and privacy protection,** and put customers in control of their data. In some jurisdictions, open banking regulation already mandates this. But banks that take a proactive approach to empowering customers could differentiate from competitors.
- **Emphasize ethics and transparency.** As the use of artificial intelligence (AI) and machine learning in decision-making increases, the rationale for these decisions can be opaque, and subject to unintended bias. While some of these effects can be limited by good governance and ensuring the diversity of the teams developing algorithms, it is critical for banks to have clear audit trails for decisions, and to be able to explain, in simple terms, the rationale behind any decisions to customers.
- **Ensure open communication.** Bad press around data leakages, or unjustified credit decisions will impair trust in the sector. Past experience shows that the least impacted firms within and outside of financial services are those that have taken time to acknowledge the full impact of a breach and build confidence with customers that it was being effectively resolved. At a minimum, banks should test such scenarios to ensure an effective response when something does go wrong.

2. Make it simple and seamless

Customers are demanding dynamic, customized experiences that predict and meet their needs in real-time. And they want interactions to be simple.

According to the Edelman Trust Barometer,[7] almost three quarters of customers expect financial institutions to use technology to make it easier to engage with them. Similarly, the 2019 EY FinTech adoption survey highlights that one of the reasons SME adopters chose FinTech is their 24/7 availability.

[7]2019 Edelman Trust Barometer, https://www.edelman.com/sites/g/files/aatuss191/files/2019-02/2019_Edelman_Trust_Barometer_Global_Report.pdf

73%

of people agree their financial services firms should lead on creating and using emerging technologies that make doing business with them easier.

Source: 2019 Edelman Trust Barometer

Banks need to focus on the "brilliant basics" — giving both personal and business customers a positive experience that meets their needs. This starts with fast, digitized online customer onboarding, enabled by new technologies that allow them to conduct their own KYC reviews and get instant decisions and disbursement of credit.

Technology can also help banks bridge the industry's "advice gap" and deliver the right advice to the right customer at the right time. Many banks have already piloted video tellers and AI-driven business advisors, while others are offering products that seek to positively influence overall customer wellbeing.

Delivering the simple, easy experiences customers want depends on banks building a deeper understanding of them — using technology and data insights to know them better than they know themselves and being ready to support them, not just through their major financial moments, but in all the moments where a decision or transaction is made.

3. Help customers achieve bigger goals

Banks that consistently outperform the market take a strategic approach to meeting customer expectations. They identify a target customer segment and work systematically to understand this segment to develop and market relevant products, allocate investments in capital, ensure management focus, maximize share of wallet, and guide virtually every other significant decision.

Banks must shift from the traditional "product-push" approach to one focused on helping customers achieve their wider ambitions. For consumer banks, this may mean helping customers prepare for big life events, such as weddings or retirement, building their financial skills or achieving major goals such as buying a home.

One bank in Tennessee has decided to target customers in a clearly defined set of communities. By focusing on meeting the needs of this specific group, the bank has lifted ROE above the cost of equity.

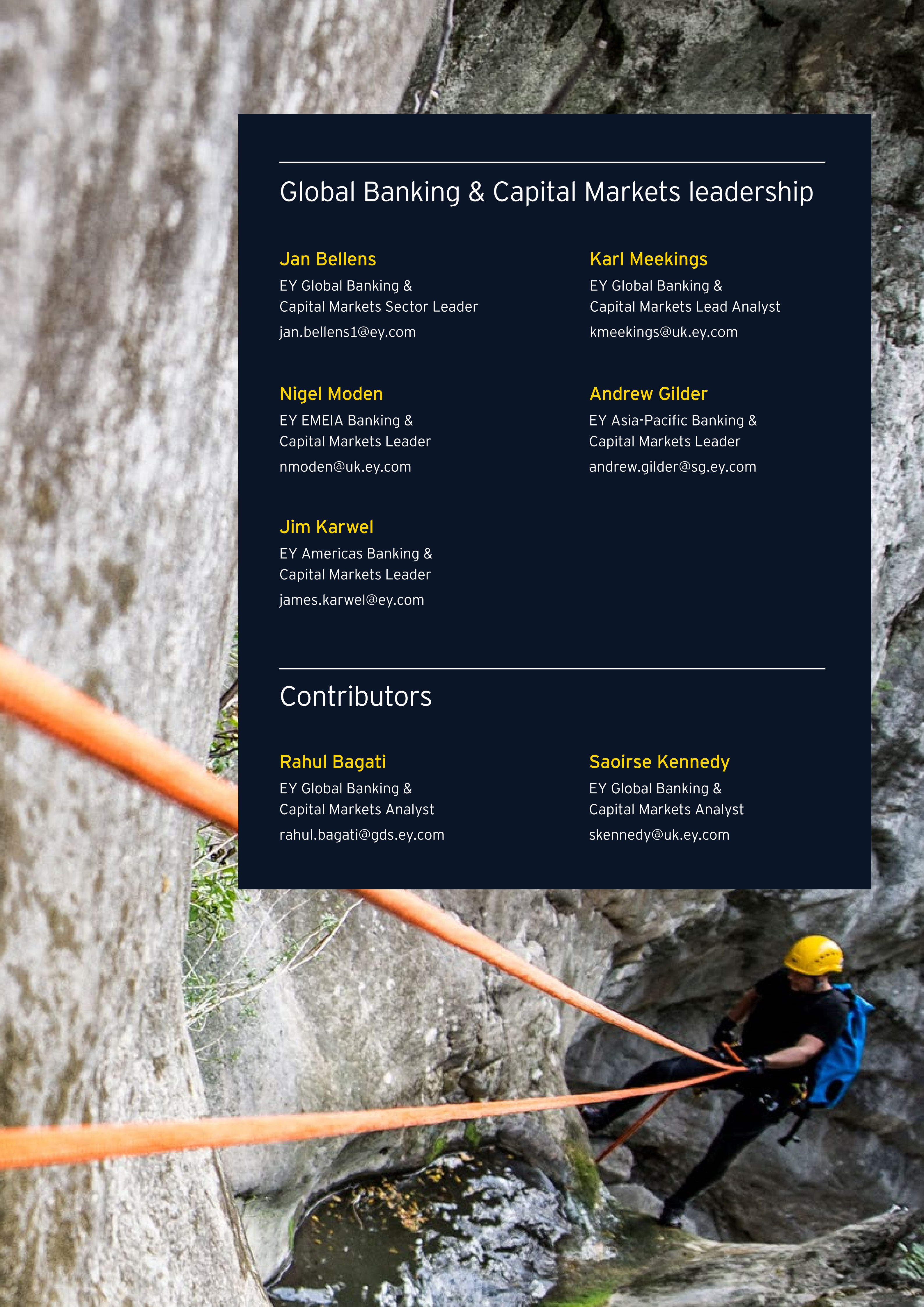
For banks serving SMEs, it's time to go beyond the "brilliant basics" and add more value by:

- Connecting clients to an ecosystem of suppliers and distributors
- Providing data-driven insights on customers, products and regions that support growth
- Supporting productivity with a range of services, including Human Resources (HR), talent, tax and regulatory compliance provided by bank partners
- Navigating larger commercial customers through increased business risk and helping them enhance performance in a weak market

Banks with corporate customers can also reap the benefits of a targeted approach. A high-performing bank in the Philippines focuses on serving just a few industries, including transportation, using its deep knowledge of these sectors to offer clients relevant services across all aspects of the business.

Building on trust to improve experiences

Changing expectations and increased competition make it even more challenging for banks to remain relevant to customers. But, high performing organizations know that creating a customer-focused culture is critical to lifting profitability in tough conditions and allowing investment in the digital transformation programs that will drive long-term value. Building true customer centricity does not happen overnight, but banks can begin now by building on the latent trust of existing customers, improving their experience and taking a strategic approach to meeting wider expectations.



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