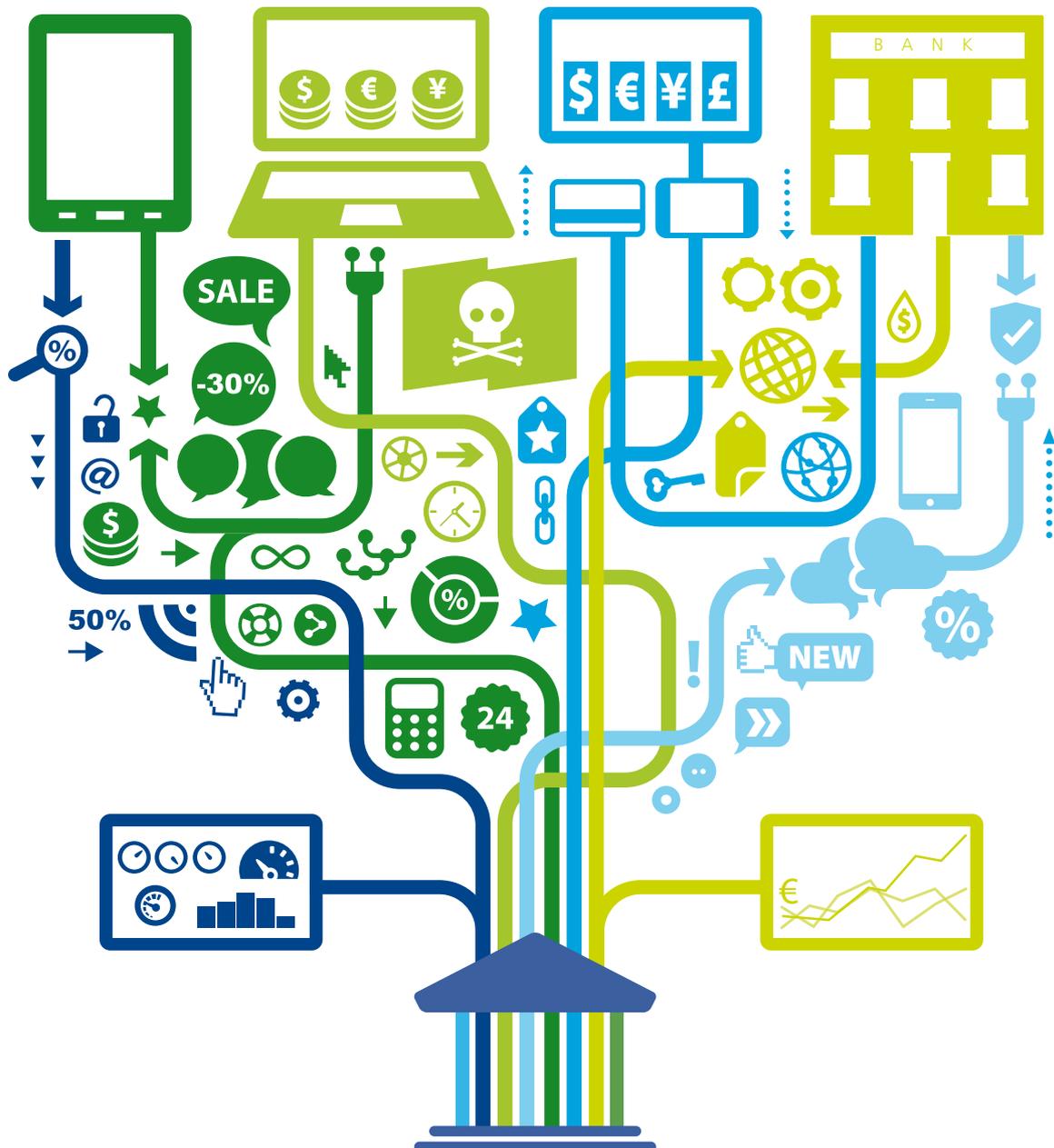


Banking disrupted

How technology is threatening the traditional European retail banking model



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Foreword

Retail banking has an impressive track record of weathering storms. For decades, industry experts have prophesied its demise with each new wave of technology. But innovations like telephone banking and the Internet did not radically change the face of retail banking. For the most part, incumbents survived by making incremental adjustments to their business models.

So, senior bankers might be forgiven for taking a sceptical approach to the latest prognostications about “the growth of the ‘de-banked’ consumer who doesn’t need a bank at all”.¹ They have also been preoccupied with addressing the more pressing challenges of withstanding the recent financial crisis, and adjusting to a tsunami of re-regulation. This has distracted them from the need to respond to longer-term threats.

However, Deloitte sees this time as being truly different. Banks’ core competitive advantages over new entrants are being eroded by technology and regulation. This will make the fight to generate returns above the cost of capital particularly challenging. Deloitte’s leading specialists in retail banking have produced this report to shed light on how best to achieve this.

Banks are faced with tough choices. They must first identify the aspects of their business model they can sustainably defend, and invest in them. In the short term, they should take advantage of a period in which central banks are providing unprecedented cheap funding to generate profits. These earnings are temporary in nature, and should be invested in strategic priorities, such as analytics. New analytical capabilities will enable banks to optimise their branch networks, and allow them to exploit their unrivalled treasure trove of data.

Finally, this short period of cheap funding offers a window for banks to choose how to address legacy systems. The case for transformation may be tough to make, thanks to long time-scales, high costs, and the difficulty of managing the process. But regulators’ patience with customer service outages is waning. This is likely to force banks to fix their systems.

These challenges are daunting for bank executives already ‘battle-weary’ from the stress of dealing with the aftermath of the financial crisis. But the short-term protection offered by cheap funding must not be wasted. Rather, it offers banks the opportunity to redefine themselves for the new digital age.

Deloitte sees this report as initiating an important discussion about the future of the industry. The primary focus of this analysis is technology. But changes in regulation and political and economic forces will also have a powerful say in the fate of retail banking.

We look forward to hearing your thoughts on this report and, more broadly, on the future of retail banking.

Kind regards,



Zahir Bokhari
Banking Leader, Deloitte UK



Executive summary

- European banks' ability to earn returns above the cost of capital in the long term will depend on whether they can pass on the cost of holding higher regulatory capital.
- This largely comes down to the degree of competition in the market and, specifically, the threat posed by new entrants and substitutes.
- Banks' ability to raise margins will also depend on the regulatory environment. The UK, which is home to Europe's largest financial centre, has placed customer outcomes at the heart of its regulatory agenda. It is also pursuing competition as a way of achieving its objectives. And the UK's Financial Conduct Authority (FCA) is using behavioural economics to ensure that banks do not rely on behavioural biases to gain financially at customers' expense.
- European banks may be taking comfort from the fact that they saw off similar threats in the past, notably the challenge of Internet banks in the late 1990s, and the encroachment of securities markets that radically changed the structure of US financial services.
- However, the first phase of Internet banking competition was supplier driven. Customers are now used to engaging directly and immediately with retailers, and to their needs being anticipated across a range of products and services. They expect similar responsiveness from their bank.
- The two core competitive advantages that banks deployed in the past to fend off previous attacks from new entrants and the capital markets have been dramatically weakened. By contrast, non-bank challengers are notably stronger than those of Web 1.0.
- Oligopolistic access to cheap funding is under threat.
- New, technologically-enabled forms of competition and the regulatory agenda limit banks' privileged access to customers and, therefore, their ability to cross-subsidise loss-leaders through high-margin cross-sales and 'back-book' pricing.
- This will shrink the revenue pool available to incumbent banks materially and, in turn, expose the significant inefficiencies in banks' cost bases. These forces will undermine the traditional integrated banking value chain.
- Consolidation would be the natural response, but regulatory conditions may preclude this approach. Banks are, therefore, likely to end up having to re-engineer their own business models and customer value propositions.
- Deloitte fears that banks risk being caught out as market sentiment shifts to favour business models better-suited to this new order.
- Banks must, therefore, begin a more radical transformation of their cost base now.
- Banks will also need to focus on developing distinctive capabilities in those markets where they can maintain sustainable competitive advantage across the cycle. This is separate from more transactional products, where profitability will ebb and flow, and where banks should resist building excess fixed costs at the top of the credit cycle.
- Banks should also use analytics to exploit their treasure trove of customer data and match the experience provided in other industries.
- In short, Deloitte believes that banks need to expand their strategies from cyclically-driven balance sheet optimisation to a longer-term vision suited to a world where the way in which people bank, invest and borrow, will be very different from the past.

Introduction

We believe European banks face threats from a number of quarters, which often over-lap and reinforce each other.

First, the key 'old world' threat to both sides of the balance sheet is the expansion of securities markets, as has happened over several decades in the United States. As European banks shrink risk-weighted assets and their lending capacity remains constrained, companies will raise more money via capital markets, much as they already do in the US. The corporate bond market has already grown significantly, while non-banks are taking a growing position in commercial real estate (CRE). Moreover, the growth of peer-to-peer (P2P) lending demonstrates how non-deposit funding is gaining increasing access to small businesses and individuals.

The more that borrowing shifts to capital markets, the wider the pool of these alternative asset classes will grow, and the greater will be investors' comfort with them. This in turn shrinks bank deposits, a core source of funding on the liability side of the balance sheet.

A second threat is that a group of businesses are looking to enter traditional banking markets. Here, the ambition is to capitalise on an expected cyclical upswing in profitability. Their hope is that competition from banks will be muted as they repair their damaged balance sheets and reputations. Start-ups with experienced bank management teams have found it relatively easy to secure investment on this premise.

Third are the independent aggregators, like the UK's MoneySuperMarket.com. Aggregators' principal attraction is their ability to offer 'best buy' comparison tables. Such comparisons are much more easily made online than in pre-Internet days. Their position as the go-to place for the cheapest, or 'best of breed,' products has been further strengthened by the network effects of the Internet.

They are increasingly looking to optimise customers' financial holdings on an on-going basis, through analysis of purchasing patterns across their customer base, reducing the competitive advantage banks used to have based on their privileged access to customers and their data.

Fourth are emerging business models using new technology to re-invent key elements of financial services, e.g. payments specialists like PayPal and Square. Other examples include P2P 'lenders' – which are really exchanges – bringing together borrowers and investors in a highly cost-efficient manner.

Finally, there is much talk of the threat posed to banks by other large players outside financial services, especially technology companies. We agree that there is a threat, but believe that the nature of that threat is often ill-understood.

The real danger to banks is not that the likes of Google or Apple will one day support a banking subsidiary with a huge balance sheet. There are many drawbacks to such a strategy: the size of the capital base required would fundamentally change their investor proposition. Moreover, the impact of intense regulatory scrutiny would limit their ability to innovate in their core business. Non-bank entrants also need to work out how to deal with problem loans to avoid brand damage from repossession or foreclosure. One option is simply to sell the debt pre-repossession.

We believe, therefore, that the danger is not that non-banks replicate the universal banking model but rather that by innovating around it in support of their own core business, they fundamentally undermine the traditional integrated bank business model.

The danger is not that non-banks replicate the universal banking model but that by innovating around it they fundamentally undermine the traditional integrated bank business model.

Ultimately, the challenge to European banks is not that any single new entrant or model will emerge that will dominate their market. Rather, the risk is that the combination of attackers across banks' eco-system will steadily erode their core competitive advantage, resulting in a much smaller banking sector, much as we already see in the US.

As the revenue base erodes, so the excess costs of a banking sector hamstrung by legacy IT infrastructure and an outdated distribution model will become unsustainable. Those banks that already enjoy a low cost-to-income ratio, such as Santander and Danske Bank, will be better placed than others to respond to competition. For others, the conventional response – consolidation and wholesale cost-cutting – is likely to be challenged by regulators keen to avoid 'too big to fail' problems and sceptical of incumbents' ability to put customer interests at the heart of their strategies.

Banks will, therefore, need to re-invent themselves, with a new vision of how they can best serve the financial needs of retail and business customers, and an operating model and cost base designed around that vision.

Two clear alternatives emerge. Some banks will accept that they will not be able to subsidise loss-leading products. Instead, they will focus on providing best-value products with very efficient distribution and servicing. They will attempt to offset some price competition through their brand, e.g. a reputation for efficiency and convenience.

The second alternative is for banks to focus on using customer data, insight, knowledge and relationships, and their brand, to cross-sell. Even here, the need for efficiency remains, as new competition will limit the premium they can charge.

1. Banks' traditional competitive advantages

To understand why we believe retail banking may be subject to disruption, one must first understand the two core drivers of banks' competitive advantage hitherto:

a) Lower cost of funds

Banking is a licence to borrow cheaply. Pension, hedge, and sovereign wealth funds, large corporates and individuals can lend money to retail and commercial borrowers via banks or through the securities markets. In many cases, the cost of originating and underwriting this lending is cheaper without the involvement of banks.² But banks can generate economic returns at a lower price point because they have unique access to low-cost leverage, primarily in the form of deposits.

Deposits are one of the cheapest forms of borrowing for a number of reasons.

Depositors are prepared to accept a lower return in exchange for security. In the past that meant the physical safety of bank vaults. Today, it lies in explicit government guarantees, in the form of deposit insurance of €100,000 throughout the European Union (EU).³

Secondly, banks have been the most convenient way of managing money. This has evolved over time from the convenience of depositing and withdrawing cash from a local branch or ATM, to a range of payment services that make the process of sending and receiving funds remarkably convenient.

In Europe, there have historically been few alternatives that deliver better returns while offering desired levels of liquidity.

In addition to the benefits of deposit funding, banks have also enjoyed a cost of funds advantage in wholesale markets. The longevity of banks, combined with an implicit government guarantee, meant that before the financial crisis banks could source funding much more cheaply than their corporate peers, despite operating at what now seem extraordinary levels of leverage.

b) Privileged access to customers

In the past, banks have cross-subsidised loss-leading pricing in key areas of the business through two key techniques: cross-selling adjacent products and back-book pricing.

Branch staff have historically been heavily incentivised to ensure customers opening current accounts are cross-sold credit cards and other loans and, in turn, insurance products linked to these loans. Convenience and customers' lack of financial sophistication enabled banks to make high margins on these adjacent products.

Banks use 'go-to rates' to attract depositors, but these rates often fall after a period of time. Banks build up big low-cost back-books because so many customers fail to switch accounts after 'teaser' rates have expired. New entrants are unlikely to pursue these tactics because these books take a long time to build and such practices are increasingly attracting regulatory scrutiny, especially in the UK. Moreover, without a core current account base, new entrants find themselves attracting customers hunting high rates, who are less likely to fall prey to inertia.

European banks have been remarkably astute in combining these two core advantages to fend off attacks, both from the wave of new entrants that accompanied the rise of the Web in the late 1990s, and the encroachment of the securities markets into traditional banking that so radically restructured US financial services.

But there is clear evidence that both of these elements of competitive advantage are under threat. Moreover, many potential tech entrants enjoy investment firepower and are better-positioned to exploit the opportunities offered by technological change. Add to that the regulators, who are increasingly tackling sharp practice in both cross-sales and back-book pricing, and the old model of banking looks in serious trouble.

2. How low base rates destroy current account economics

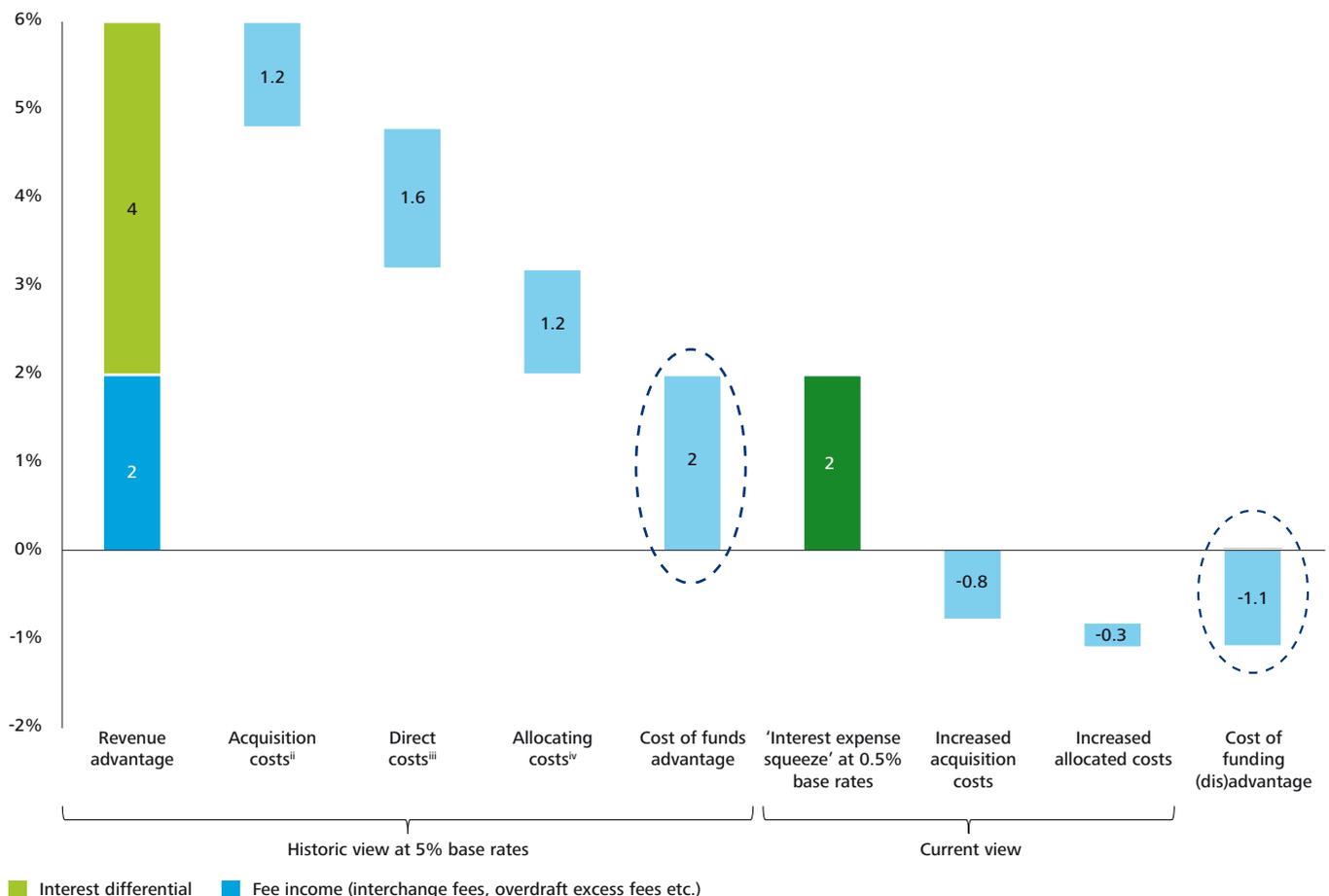
While this report is primarily concerned with long-term, structural threats to bank profitability, we cannot ignore how the low base rates that have prevailed since the financial crisis undermine traditional current account economics.

The interest rate paid by banks on current accounts is typically significantly lower than those paid for lump sum deposits (and the rates paid to borrow in the wholesale markets). However, this interest rate does not reflect the full cost of acquiring and servicing these current accounts. In the past, these acquisition and servicing costs were offset by the fact that banks did not have to pay very high interest rates on current accounts.

Until the financial crisis, central bank interest rates (the 'base rate') were traditionally much higher. This meant that current account rates could easily be 500 or more basis points (hundredths of a percentage point) below lump-sum deposit rates.

Because base rates are at unprecedented lows, that maths does not work. Base rates have been low since 2009, and central bankers have signalled that they are likely to stay that way for some time yet. Figure 1 shows the economics of current accounts in the UK, where banks typically do not charge for them. A 200 basis point margin generated by current accounts when base rates are at 5 per cent turns into a 110 basis point loss at a 0.5 per cent base rate.

Figure 1. Indicative costs of funds advantage for a UK current account versus interest ratesⁱ



Source: Deloitte analysis

- i Assuming average balance of £2,500 for a current account
- ii Assuming £150 handling for a current account
- iii Cash funding (including ATM, interchange), cheque processing etc.
- iv Branch and call centre staff, central costs etc.

3. How deposit guarantees and new technology are lowering barriers to entry

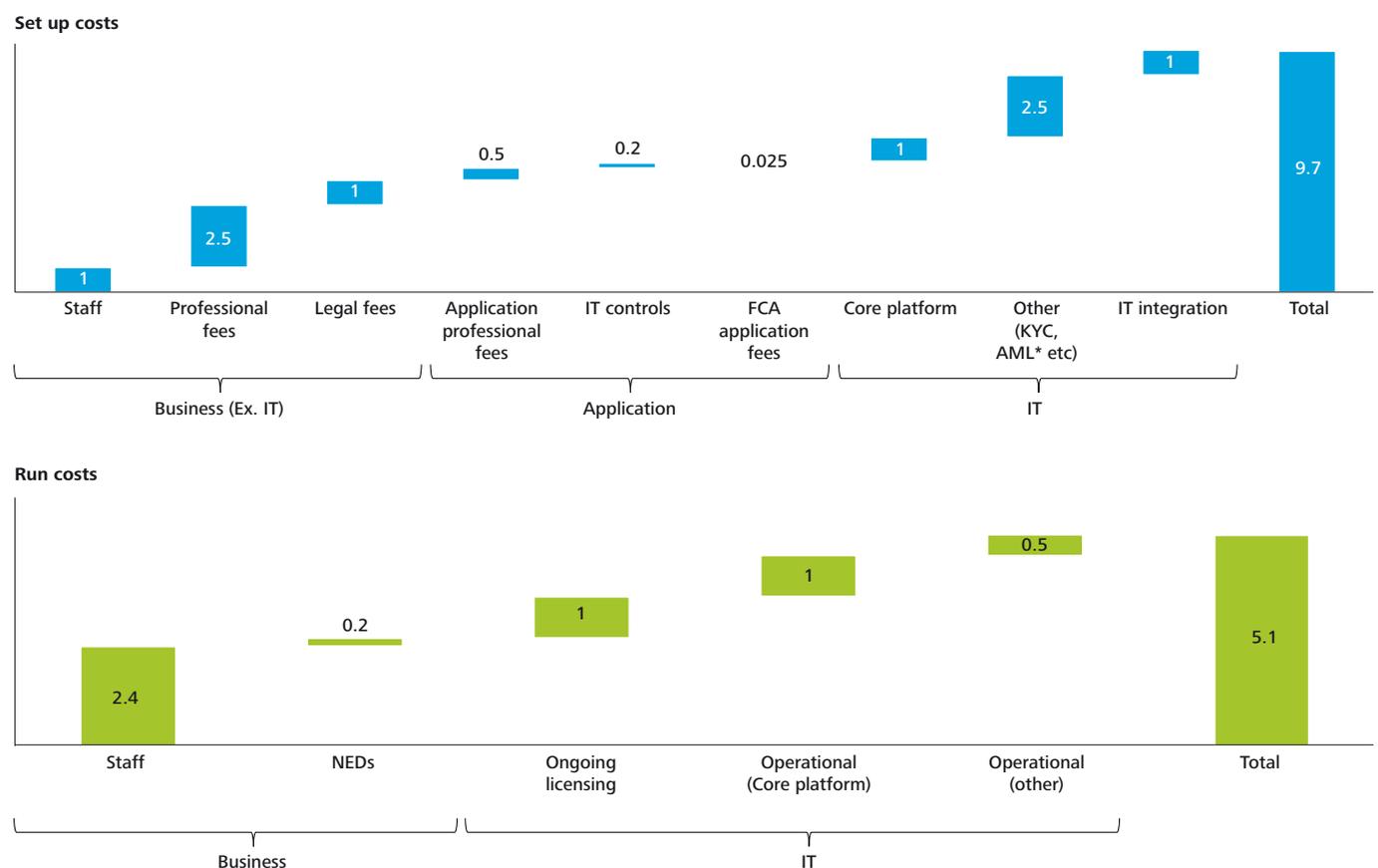
The recent failures of both large and small banks across the world highlighted that banks are not immune to the threat of insolvency, and also that they are subject to systemic risk. In response, European governments have developed transparent, actively-marketed deposit guarantee schemes. The guarantee in EU member states is much more generous than before the crisis. Most customers are now aware that deposits held with any member of such a scheme is effectively underwritten by up to €100,000 by the state, compared to €20,000 until 2009.⁴ The logical conclusion for those with deposits below these thresholds, i.e. most retail customers, is that incumbent banks have lost their perceived security advantage over challengers.

This generates a very clear arbitrage opportunity for new or niche banks that may previously have felt they lacked the brand strength or heritage to compete. Whether and to what extent customers will move to these new players remains to be seen.

The first wave of Internet banking in the late 1990s showed how susceptible large deposit balances are to disruption, with unfamiliar new entrants like ING Direct and ICESave taking significant share of new business in this segment across a number of European markets. The recent wave of new banking licence applications shows that players that previously relied on wholesale funding, like credit card or mortgage monolines, see lump sum Internet deposits as an easy market to tap, and one that may prove more resilient than their more traditional sources of bank or capital-market funding.

The newly-level playing field has been reinforced by technological developments. Deloitte assesses that it can cost less than £10mn to set up a relatively simple small bank, and just £5mn per annum to run it on an ongoing basis, thanks to off-the-shelf software. (Note, however, that licensing costs tend to be variable, so running costs will rise with customer numbers.)

Figure 2. Indicative costs for a new bank (£mn)



* Know your customer, anti-money laundering

Source: Deloitte analysis

Deloitte estimates that the lump sum savings market accounts for about two-thirds of total deposit balances across Western Europe. Aggregators, with their comparison tables, make accessing this huge market as straightforward for new entrants as obtaining wholesale funding.

The extent to which these new entrants will destroy the funding advantage of incumbent banks will largely be dictated by their cumulative appetite for these deposits. This, in turn, will partly depend on the ease with which new entrants can access profitable opportunities to deploy these deposits.

In mortgages, for example, where broker channels provide easy access to customers, the appetite for deposits among new entrants will extend as far as players can make economic returns on mortgages funded by Internet deposits. Other lending markets are also increasingly opening up to new entrants without distribution capabilities of their own, driven by the rise of aggregator and P2P models (of which more follows).

Aggregators make accessing huge savings markets as straight forward for new entrants as obtaining wholesale funding.

4. How technology enables new payments providers to rival banks' convenience

As outlined earlier, current accounts give banks access to less price-sensitive savings. They capture customers' 'working capital', and give the current-account provider first call on surplus capital as it is generated. This helps to build a middle/back-book of less price-sensitive savings.

In some European countries – among them the UK – the banks control access to the bulk payment schemes. They also own the large ATM networks and charge other banks for access. Alongside 'free' current account banking, this raises the barriers to entry and reduces competition.

However, regulation and technology are combining to open up the market to competition.

Electronic payments have become key to providing convenience to customers, as the use of cash diminishes, and with it the importance of a physical presence. Payments innovation is coming primarily from non-banks, like PayPal. Moreover, cash-rich Internet players, such as Google and Apple, are also demonstrating an interest in this space. Google Wallet, for example, invites US customers to "Shop. Save. Pay. With your phone." Apple's Passbook enables users to store airline boarding cards, coupons and vouchers on their iPhone. Apple has also been marketing iBeacons, a system that can send special offers from retailers to nearby iPhones. Apple's CEO Tim Cook said in January that "the mobile payments area in general is one we've been intrigued with."⁵

Payments are attractive to these players because they offer control over the customer purchase experience and ownership of a rich seam of transactional data – from which the new entrants have a proven capability to use new technology and analytics to extract value.

Regulators are giving them a leg-up by making it increasingly difficult for banks to exploit their ownership of the payments network as a barrier to entry.⁶

The danger for banks is that the current account balances that they currently own or control, will reduce. One risk is that some of the 'float' associated with current accounts may come under the control of the new entrants, even if they do not go so far as to obtain the banking licences required to offer current accounts.

Another risk is that non-bank players obtain banking licences in order to offer narrowly-defined current account products (probably without offering a full suite of traditional banking products), to take market share in transactions.

Regulators are giving new entrants a leg-up by making it increasingly difficult for banks to exploit their ownership of the payments network as a barrier to entry.

5. How digital banking is upending traditional current account economics

In the past, the costs of the branch network were reallocated across a wide range of products sold primarily in branch.

Now, more and more of the supplementary banking product sales traditionally made in-branch, and allocated in such a way as to offset the costs of current account provision, are moving online and/or through intermediated channels.

In France alone, four banks are already using digital tools to improve customer experience. Crédit Agricole Centre-est has launched a 'like your banker' campaign. This initiative allows young customers to select their customer advisor on features such as age or hobbies, to give their preferences for appointment times and to share information about their projects.

Société Générale has created 'SG and you,' which offers a new relationship model to its clients: they are allowed to ask any questions 24/7 on any subject, to suggest innovations and to rate implemented ideas.

AXA Banque 'SOON' is one of the first bank services to be specially designed for a mobile smartphone, with the objective of making banking useful, simple, and pleasant. Focusing on design and user experience, AXA took Apple as an example and used Nudge theory from behavioural economics to develop useful tools to manage money.

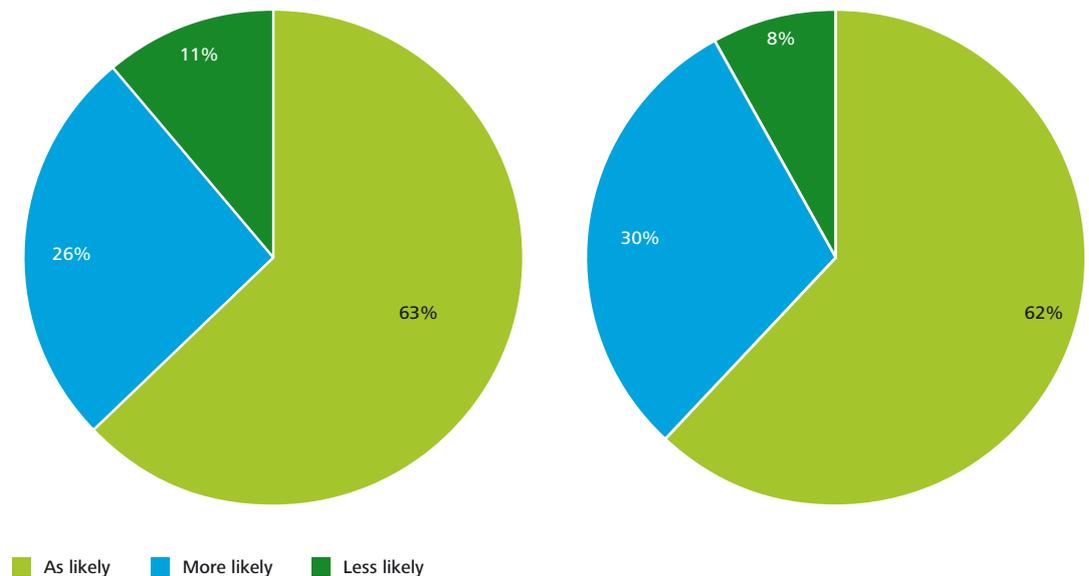
BPCE Banque Populaire and Caisse d'Épargne have begun to pilot 'Dilizi', a 'digital cash register', much like US company, Square's, that allows shopkeepers, artisans and NGO organisers to turn their smartphones into a bank card payment terminal.

Serving customers via new channels in this way makes perfect sense. Customers prefer it. Online engagement drives loyalty, raises net promoter scores, and is cheaper at the margin. See figure 3.

Figure 3. New channels promote branding and customer loyalty

Question: Since you started using mobile banking, how likely are you to recommend the bank(s) you use for mobile banking?

Question: Since you started using mobile banking, how likely are you to stay with the bank(s) you use for mobile banking?



Source: 'The Rol of Mobile Banking', Forrester Research. See: <http://www.forrester.com/The+ROI+Of+Mobile+Banking/fulltext/-/E-RES58504?objectid=RES58504>

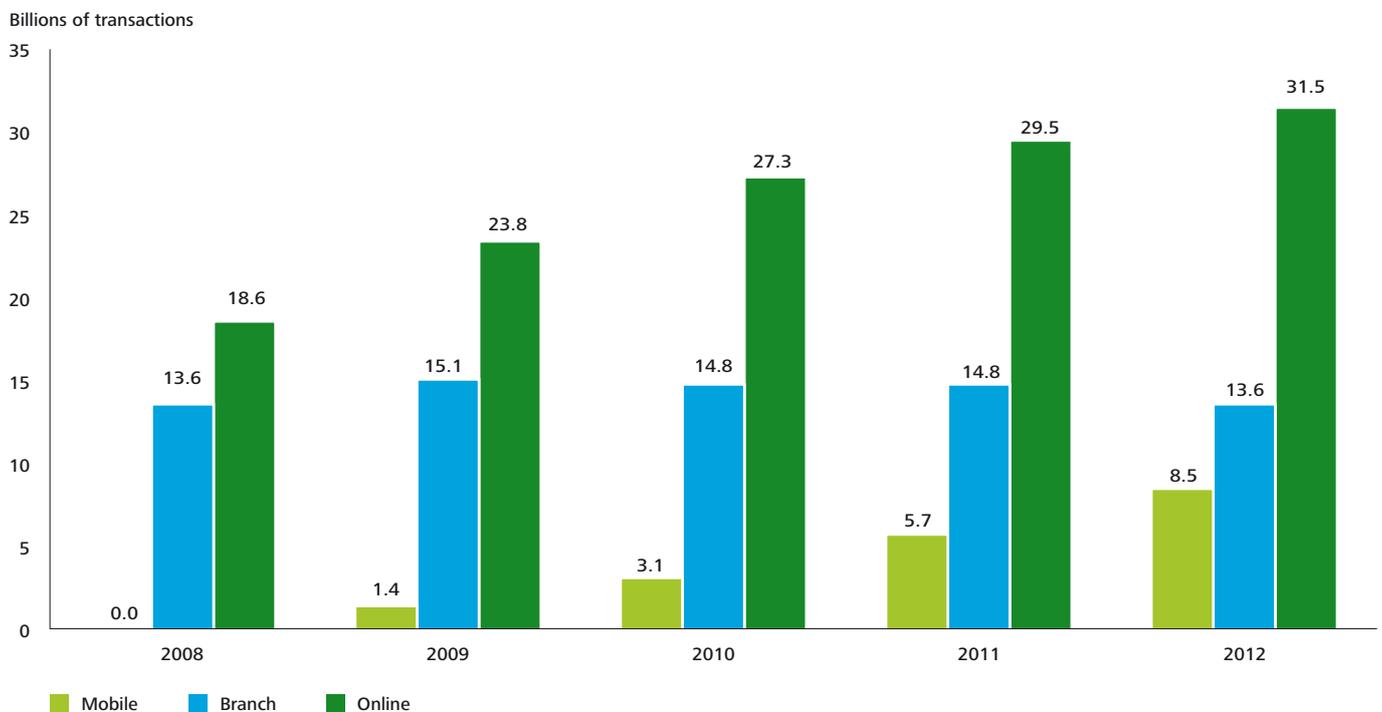
Bankers have been hoping such new online and mobile channels would reduce the significant costs of running huge branch networks. Banks are already reshaping for the digital future – they cut 5,500 branches across the EU in 2012 alone.⁷ Unfortunately, lowering the fully-loaded cost of current account funding is not as simple as cutting branch numbers in line with the reduction of branch transactions.

Costs only come out through branch closures and/or staff reductions. Two factors complicate the process. The first is that many of the ‘lower cost’ mobile transactions are additive rather than substitutive. Online banking has broadened the scope of communication between banks and customers. This means that the decline in branch transactions is not as steep as the growth in alternative channels might imply. See figure 4.

The second and more profound issue is the impact of branch closures on customer economics. Closing branches and/or reducing branch staff only increases margin if the cost reduction is greater than the resultant revenue dilution. This is not a straightforward calculation. Deloitte’s recent experience suggests that the average cost saving from closing a branch is around £200,000. A large bank closing 500 branches saves around £100mn a year. Not bad, but that is the equivalent of just 100 basis points on a £10bn deposit book.

That trade-off between cost savings and net interest margin is crucial: banks know how to manage margin through their branches. As an example, when Deloitte worked with Metro Bank on their original business case, its founder, Vernon Hill, assumed that he could gain a 75 basis point cost of funds advantage by being smart about branch banking. As with Mr Hill’s Commerce Bank in the US, Metro Bank uses high-footfall locations, better branch configuration, longer opening hours and a service ethic for front-line staff to attract deposits.

Figure 4. Transactions going online and mobile in the US



Source: Deutsche Bank; TowerGroup, Deloitte analysis

Banks seem much less capable of managing margin and acquisition costs online. There simply is not as much 'passing trade' online as there is on the high street.

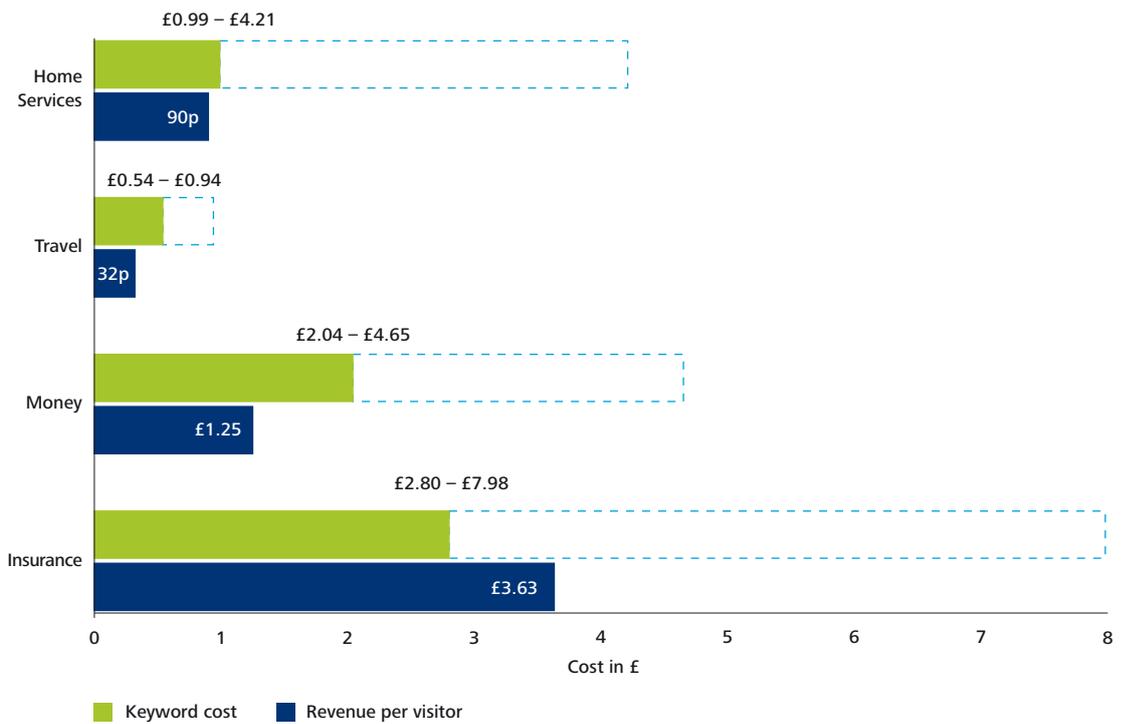
Other industries (e.g. estate agency, insurance, travel) have seen the rise of aggregators who have taken margin from existing providers. Search engines have also been able to capture a significant part of the value chain through auctions of paid search advertisements. As an example, Deloitte compared the revenue per visitor as reported by MoneySuperMarket.com in its most recent (2013) annual report, to suggested keyword costs from Google AdWords.

This shows that for a large proportion of popular keywords, the search engine is likely to have captured significantly more value than the aggregator. See figure 5.

A successful search engine can extract more than the revenue, let alone profit, per visitor, for those customers delivered via paid search using that search engine.

In this competitive environment, banks are forced to use heavy marketing and promotional pricing to drive new customers directly to their websites, significantly diluting returns.

Figure 5. Typical keyword costs and revenue by sector, MoneySuperMarket.com



Note: These figures are based on a sample of c.700 most popular keywords per each of MoneySuperMarket's four key sectors. The keyword costs listed refer to the interquartile range.

Source: Deloitte analysis, Google AdWords, MoneySuperMarket.com 2013 annual report, p.14-17.
See: <http://corporate.moneysupermarket.com/>

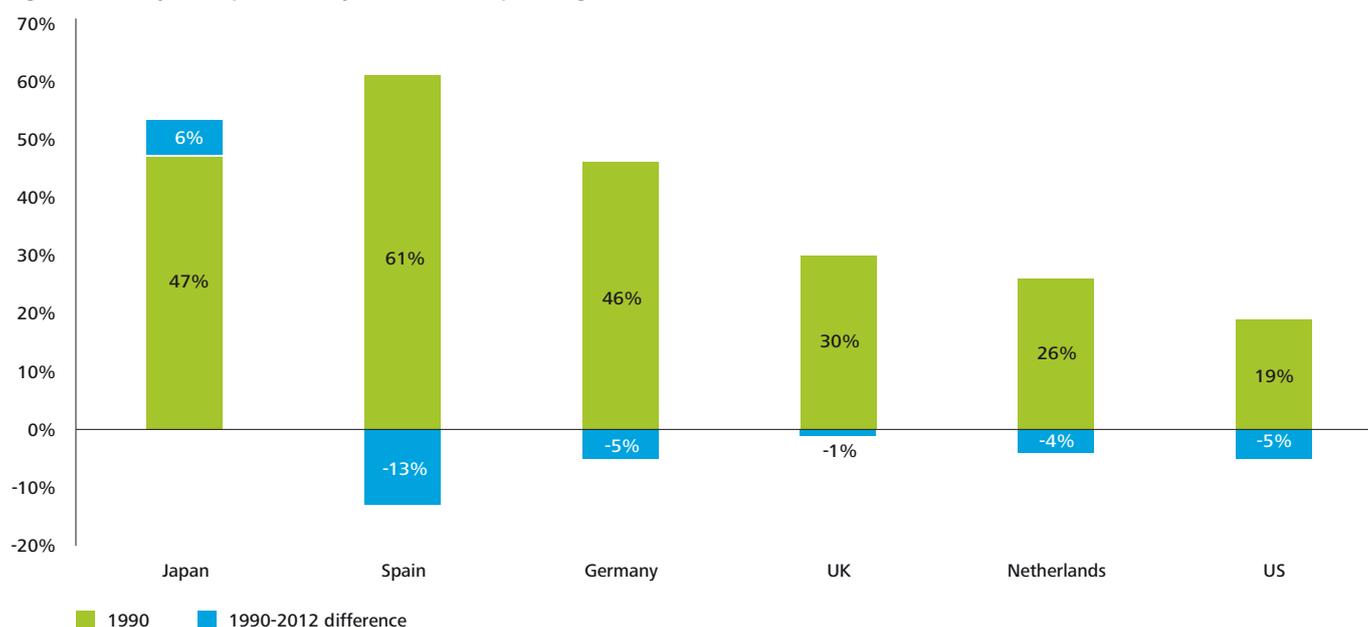
6. How technology is exacerbating the threat from the capital markets

If banks lose their near-monopoly on cheap money in the manner outlined, then their competitive advantage vis-à-vis the capital markets is dramatically reduced.

Fifty years ago, deposit intermediation (i.e. the funding of loans by deposits) was ubiquitous.

But the combination of technological and financial innovation prompted a rapid expansion of the securities markets at the expense of deposit intermediation, particularly in the US. In 1990, 19 per cent of US household assets were in bank deposits. Now, this figure is under 14 per cent.⁸ See figure 6.

Figure 6. Currency and deposits held by households as a percentage of total household financial assets



Source: OECD's National Accounts - Financial Balance Sheet, Non-Consolidated

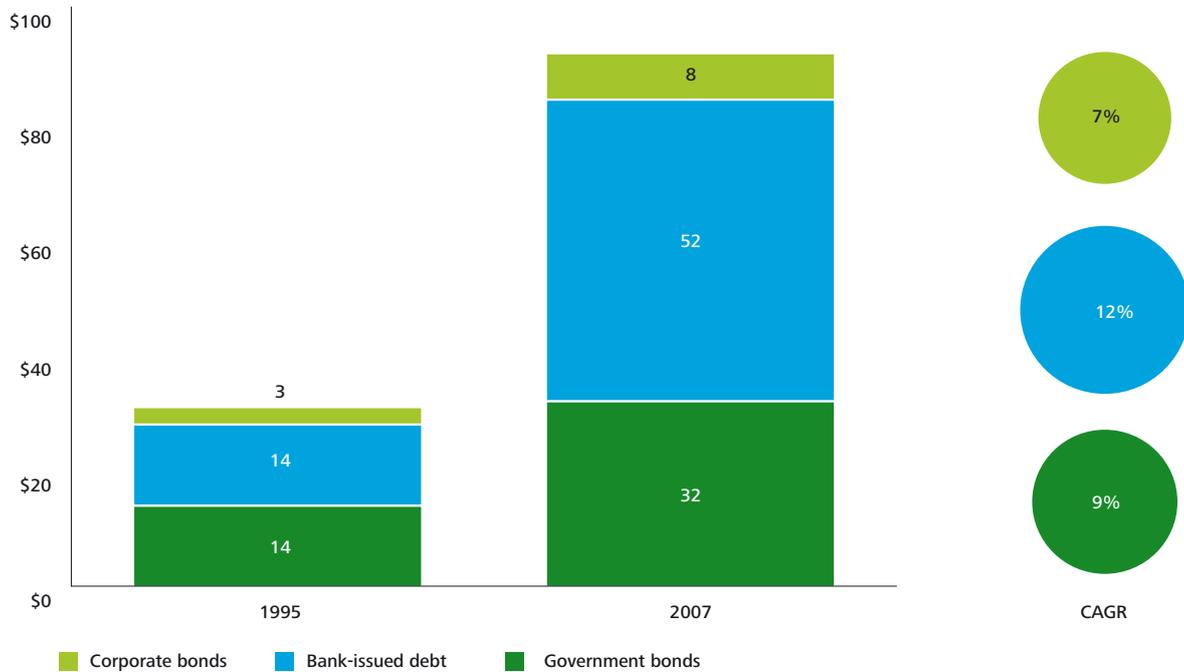
If banks lose their near-monopoly on cheap money, then their competitive advantage vis-à-vis the capital markets is dramatically reduced.

In Continental Europe and Japan, bank deposits comprise a far greater share of household financial assets. Given the significant advantages over traditional banking that the capital markets offer, both in terms of lower costs and risk diversification, it is remarkable how resistant the European financial system has been to this potential substitution.

European banks' resistance to encroachment by capital markets has owed much to their ability to co-opt them. For much of the period leading up to the crisis, by far the largest customer of the debt markets have been banks themselves.

Figure 7. Global stock of debt outstanding

Trillion, constant 2011 exchange rates



Source: Financial globalization: Retreater reset?, McKinsey, 2013, p2. See: http://www.mckinsey.com/insights/global_capital_markets/financial_globalization

The stock of bank debt outstanding grew at 12 per cent compounded in the 17 years leading up to the crisis, and ended up accounting for well over half of all global outstanding debt in 2007. See figure 7.

Banks leveraged an implicit state guarantee to produce what looked at the time like the best ‘risk-adjusted’ yields available on a diversified basket of risks from across the economy. Combined with heady rates of leverage (with several large banks operating with balance sheets that were a huge 50 times their capital base) banks were in a position to out-compete the securities markets, even without a low cost deposit base.

However, the weaknesses inherent in using banks as a ‘super aggregator’ of risk in the economy have been exposed in both the current EU malaise and in Japan. European governments have been forced into massive taxpayer bailouts, at least partly thanks to the concentration of risk on bank balance sheets.⁹

Moreover, central banks have had to undertake extraordinary measures to try to re-inject lending capacity in a banking sector unable to clear its bad debts. Japan has shown that this process can extend well beyond a single ‘lost decade’.

Regulatory policy is now unwinding the advantage that banks have held in attracting capital market debt funding. Regulators have a clear ambition to prevent banks benefiting from their position as a source of systemic risk. Senior bank debt is now designed to be 'bailed-in', to ensure that wholesale debt funding is more reflective of bank-specific risks faced by creditors. This ought, over time, to result in a much more level playing field between banks and alternative providers of finance.

While regulatory policy is shifting to favour competition for established banks, new technology has enabled disintermediation of banks at a far smaller level of financing – and, therefore, on a far greater scale – than was possible under traditional capital markets models. P2P lenders and crowd-funding embrace new technology to help individuals and small businesses bypass banks.

P2P business lending in the UK rose by 211 per cent between 2012 and 2013.¹⁰ In 2014, it accounted for £250mn of UK personal loans, but is expected by the Open Data Institute to increase to £1bn by 2016.¹¹

P2P enjoys explicit government encouragement in the UK. The British Business Bank channelled half of the £660mn that it lent last year through alternative finance providers, such as Funding Circle.¹²

P2P could well be tested severely when base rates rise, as they must, and by a less benign loss environment. However, the more banks try to squeeze profits from deposits, the more likely depositors are to embrace these alternative sources of value.

7. The loss of privileged access to customers

The second core component of banks' competitive advantage relates to their ability to cross-sell to existing customers and exploit back-book prices. This has allowed them to see off non-banks by subsidising loss-leading rates with profits made elsewhere. There is a short-term problem with this model, in the form of low base rates, and two more fundamental challenges in the longer term: regulation and new entrants.

(a) Regulatory pressure on traditional bank sales and pricing models

In addition to the huge amount of regulatory resources dedicated to improving prudential regulation since the crisis, the attention given to banks' 'conduct', specifically, the way they treat customers, has also intensified over the past few years. Regulators are addressing some of the practices that have helped banks to cross-subsidise core products.

For example, the UK's FCA is:

- cracking down on the use of incentives to encourage branch sales-forces to sell high-margin products;
- investigating back-book pricing on savings products; and
- reviewing SME banking, which could sanction banks that lend only to customers that maintain a current account.

If competition alone is unable to unwind cross-subsidies, the regulator will step in.

Some countries take a different approach. For example, some German banks continue to sell Payment Protection Insurance (PPI) even though PPI mis-selling has cost British banks around £20bn in fines and compensation to date.

However, given the relative size and sophistication of UK financial services, several other European jurisdictions tend to follow its regulatory approach. It would be unwise of banks outside the UK to assume their regulators will not follow suit, reducing their ability to cross-subsidise and leverage back-books.

(b) Independent aggregators

Pre-Internet, it was time-consuming for consumers to find an expert with whom to discuss their financial position, and possibly awkward in small communities. Online aggregation is convenient, anonymous and often offers better value.¹³ For all the banks' investment in making themselves more approachable, it remains difficult to persuade people to buy from a 'tied agent', like a bank, when it is so easy to shop around.

The evidence to date broadly supports this insight. Not only have independent aggregators secured a large proportion of general insurance in the UK, but they are beginning to take significant share in the unsecured personal loan and credit card market, too. Perhaps most significant of all, they have gone from non-participation to a 10 per cent share of deposit flows in less than three years.

But to gain traction, aggregators need to offer the best deals. They would have a problem if the banks refused to support such channels. However, for the reasons listed above, there is an increasing number of new players from outside the financial services industry offering deposits or loans and seeking to avoid the costly building of their own distribution and brand. The history of mortgage lending shows that when under pressure from competitors or substitutes, banks will defend their share through these channels, despite the long-term damage to margins.

In addition, aggregators are becoming equally sophisticated users of data, including designing their own loyalty and rewards structures. This makes it harder still for banks to make the case for proprietary channels.

The combination of shifting regulatory focus and the rise of aggregators means that banks will have to work much harder to retain value from customers. All of these headwinds convince us that banks need to radically rethink their strategy.

8. The need for a new banking strategy

While the threats outlined are very real, their extent and the time frame over which they will exert themselves remain opaque. Looking back over the first wave of disruption caused by rapid take-up on the Web during the late 1990s, there was little to be gained from being in the vanguard. Few of the Internet upstarts spawned by incumbents and new entrants survive in the same form today. By contrast, it is hard to find an example of a bank, however small and traditional, that has had to fold because it could not retain its relevance in the Internet era.

However, it is worth casting an eye across to the grocery or gambling sectors to see the consequences of too much reliance on traditional ways of doing business. In the space of a few years, an inflection point has occurred where the online business has moved from being complementary to core. The switch from floor space to online presence as the critical factor in the battle for market share has taken even sophisticated players by surprise. Those that have taken the longest to react find themselves with inappropriate real estate franchises and no clear strategy for asserting an online presence. This is reflected in lower stock price-to-earnings multiples, so that perceived laggards are at a considerable strategic disadvantage.

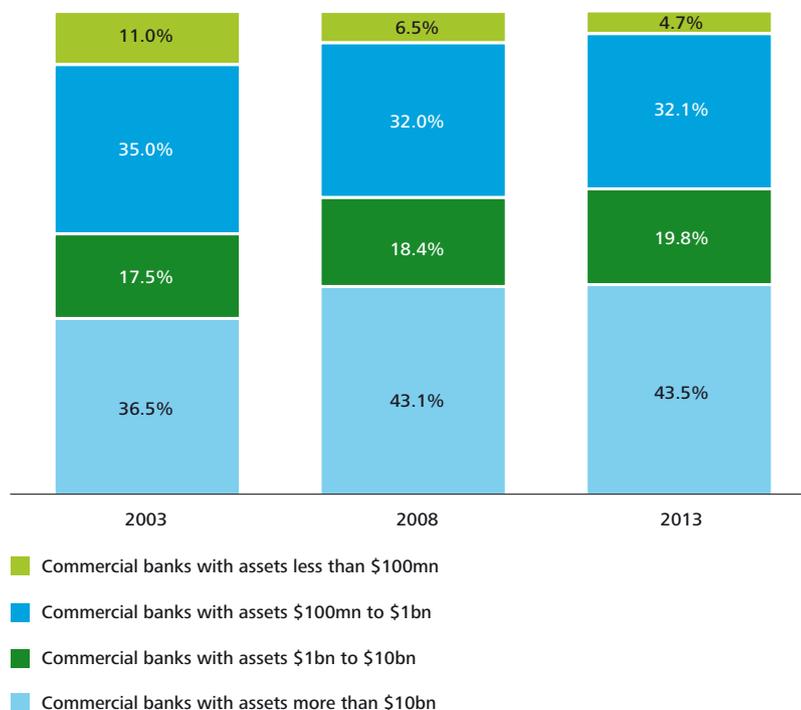
The lessons for banks are clear. They are going to have to be more aggressive in presenting the case for investment at the expense of short-term profitability. Investors, in turn, need to recognise the value that this could unlock through:

- redefining the sources of competitive advantage;
- thinking smart about customer acquisition costs and lifetime value; and
- transforming their cost base.

In the space of a few years, an inflection point has occurred where the online business has moved from being complementary to core.

9. Pick winners like SME lending and savings

Figure 8. Sources of lending to SMEs in the US



Source: Federal Deposit Insurance Corporation. See: <http://www2.fdic.gov/sdi/main.asp>

As risk appetite returns, the more commoditised areas of financial services will come under real pressure. The profits made in a cyclical recovery need to be reinvested to build a more sustainable business.

As risk appetite returns, the more commoditised areas of financial services will come under real pressure. The profits made in a cyclical recovery need to be reinvested to build a more sustainable business. Banks need to choose asset classes and segments such as SME lending that are less vulnerable to disintermediation. Small business banking in the US has remained reasonably resistant to competition from the securities market. Smaller regional banks have also largely successfully defended their share of lending to SMEs. See figure 8.

Alternative funding models, such as P2P, private placement, retail bonds and other asset-backed securities highlight that this market is susceptible to new entrants. Banks will have to find new ways of asserting themselves. This may mean co-opting elements of the new models. For example, business models like the UK's Funding Circle, a P2P lender, is closely aligned to some banks' ambitions to reinvent local banking for the digital age. Banks could provide local exchanges for this type of funding, allowing local investors to support local businesses.

We also believe that banks will have to overhaul bancassurance. Regulation such as the EU's proposals to unbundle banking and insurance products has been making life difficult for banks in this area. But we feel that the shortfall in pension provision will persuade policy-makers and regulators to reconsider the more restrictive aspects of policy in future. The UK Government's abandonment of forced annuitisation in its 2014 budget shows that change is already under way. The UK's package of reforms is likely to give a bigger role to banks in long-term savings.

10. Think smart about customer acquisition costs and lifetime value

Without a change in the economics of customer acquisition, banks risk ceding much of their revenue to search engines, independent aggregators and payment specialists. However, they retain the advantages of incumbency. We believe a reshaped banking sector can rise to these new challenges. There are three key tactics we would highlight.

First, banks must protect and better leverage the residual value from branches. There are plenty of examples where, in their eagerness to cut costs, banks have choked off new acquisitions. At one bank we worked with the removal of in-branch business advisers saw recruitment of 'switcher' businesses from other banks drop by 60 per cent. In another, the productivity uplift required of the residual branch salesforce to offset the effects of a significant cost-reduction exercise, was in excess of 300 per cent.

Banks must strike a better balance between cutting excess capacity and protecting new business share. To do this they need to understand where to have branches and what to do with them, based on a real understanding of the micro-markets in which they operate. Deloitte analysed over 10,400 bank and building society branch locations in England and Wales to understand how factors such as population, demographics and the local economy – both current and forecast – affect customers' banking needs.¹⁴

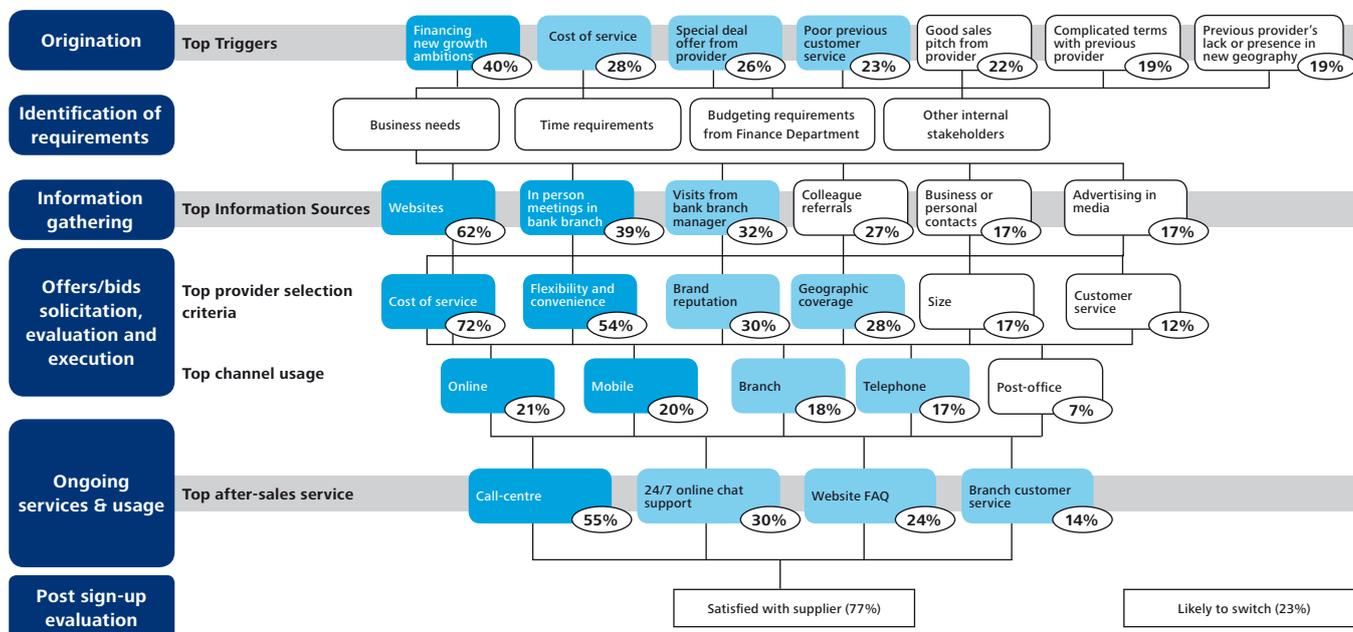
The study classified bank locations into seven key types of micro-market, which paint a new picture of consumer demands for products and services. Understanding these micro-markets is the essential first step in creating the optimum network and significantly reducing cost-to-income ratios.

Second, banks should use analytics on their customer data to improve the economics of acquisition through direct channels. Many of the segmentation strategies used by banks today focus on cost-to-serve or generic needs (e.g. life stage for retail customers, industry for SMEs). This is useful for cross-selling to existing customers. However, analytics can be used much more effectively as a cost-effective means of new relationship-banking acquisition. Clearly, truly effective analytics relies on having a rounded customer view. This is something that banks currently struggle with but which should be helped by simplifying core processes.

One tactic is to use more sophisticated pricing through intermediary channels, as airlines do through flight aggregators. Banks will also need to develop a richer understanding of the influences behind buying behaviours.

Figure 9. Target areas for marketing, service and product efforts

We have identified the primary choice drivers, influencers, channels and decision makers for the target group to enable choices on where to focus marketing service and product efforts



Source: Deloitte analysis

Monitor Deloitte conducted a study for a large telecoms company, providing a detailed picture of how different customer segments select new products and providers. (See figure 9). Without this sort of analysis, banks' marketing tools tend to be blunt, relative to those found in other industries.

Third, banks have to get better at digital cross-selling. In the aggregated digital world, the winner is most likely to be the provider that can extract the most value from the lowest price point for core product(s). In the past, banks have done this well.

However, some of banks' past practices, e.g. differential pricing for new customers ('front book') versus existing customers ('back-book'), and heavy push selling of high-margin product, are under intense regulatory scrutiny.

In future, banks will have to show a broader appreciation of customer wants and needs, and ways of generating customer 'pull' rather than relying on traditional 'push' marketing. We think that banks are going to have to focus on factors that grip customers' interest beyond their basic transactional needs.

The new US banking service, Simple, is a good example of how financial management tools can be used to present banking services to the mobile-savvy consumer.

Simple, which was founded in 2009, sells itself as an alternative to traditional banks. It does not charge overdraft fees, prides itself on a user-friendly website and mobile app, and provides customers with a debit card and access to ATMs. It also offers "automatic saving and budgeting".¹⁵ Simple was acquired by BBVA in February 2014. The Spanish bank's executive chairman, Francisco Gonzalez, has been one of the most prominent bankers to recognise the threat of digital disruption. In a Financial Times opinion piece, he wrote "Banks need to take on Amazon and Google or die."¹⁶

We expect other banks to buy technology companies as they seek to incorporate a more attractive customer proposition for both retail and business customers. But banks will need to be cautious, both that they do not overpay, and that they do not stifle the innovative cultures of these businesses.

11. Transform the cost base

Traditional banking is under severe threat from digital disruption, and it is high time to reconsider the 'core' in core banking systems.

The central challenge is that banks have designed their IT systems to support processes that deliver products across multiple channels. Bank systems are, therefore, arranged around products rather than around customers. Digital transformation, on the other hand, demands that customer data be leveraged to provide services at the point of need. A simple example is how search engines use search patterns to auto-complete search words. By contrast, the rich customer data banks collect often gets lost within product silos.

Turning this product-centred model on its head would allow banks to serve not just customer needs but also to capture their experience and address their future expectations.

This is easier said than done. Banks' IT estates cost billions of dollars to run. Unfortunately, the expenses associated with transformational change are just as daunting. As Deloitte partner Carol Larson highlights: "They [banks] are stuck in an IT nightmare. It is just so costly, both in dollars and process disruption, to make a big change, and by the time you have done it, there may be something new and different and better."¹⁷

Deloitte experience suggests that the annual costs of 'non-transformational' change in a mid-sized retail and commercial bank operating on legacy systems is now likely to be in excess of €100mn, more than half of which is regulatory-related. Meanwhile 'run-the-bank' operations and IT costs are likely to be of a similar size. €200mn of operations and IT costs are enough to wipe out profits at many banks with assets in the €50bn range. Even for bigger banks, this scale of costs makes it challenging to meet the cost of capital.

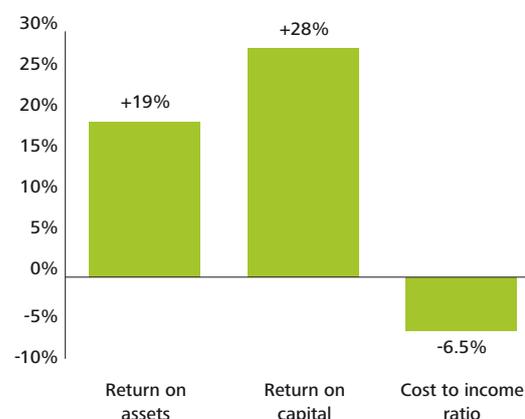
Consolidation would be the natural response. However, policy-makers are likely to see this as a step back in their ambitions to reduce systemic risk and to introduce more competition between banks. Banks will, therefore, have to work out ways to reduce their IT spend without synergies from merging.

In Germany, the Nordics and the US, there are examples of outsourcing arrangements that have enabled smaller players to operate effectively. However, the end goal – utilities shared by multiple clients – has not been achieved in markets other than these. Rather, the main benefit from the development of outsourcing businesses has been cost arbitrage by using lower-cost locations – in other words, 'your mess for less'.

Such a situation seems, on the surface, perverse, given compelling evidence of the benefits of a more fully outsourced approach. For the past five years, Deloitte has used information from The Banker database to analyse the relative performance of banks using modern core banking systems, compared to banks using legacy software. What this analysis shows is that banks running modern core banking systems have materially better profitability metrics. Over the past five years, banks using third party banking applications have enjoyed a 19 per cent higher return on assets, a 28 per cent higher return on capital and a 6.5 per cent lower cost-to-income ratio on average than banks running legacy applications. Of course, there are a host of factors that can contribute to different performance, such as business mix, risk, geography.

As an example, it is common for banks undergoing core banking platform replacement to rationalise their product offerings as part of the implementation. They change their business mix by divesting or stopping sub-scale or unprofitable product offerings.

Figure 10. Improvement in performance over five years of banks running on third party banking applications relative to those using legacy applications



Source: Deloitte, Temenos: Restoring profitability in the digital age, p9. See: <http://www.temenos.com/en/news-and-events/news/news-list-page/may/restoring-profitability-in-the-digital-age/>

Given the compelling cost advantages of modern, rather than legacy, core banking systems, what explains the reluctance of banks to make the change?

However, the differential in profitability holds not just on average over the five years, but for each year, and for each region. In other words, the correlation exists across a large data series, over time and across regions, the last being particularly important given the significant disparity between the recent performance of banks from emerging and developed economies. Given the compelling cost advantages of modern, rather than legacy, core banking systems, what explains the reluctance of banks to make the change? The answer appears to be a combination of short-termism, risk aversion and lack of suppliers.

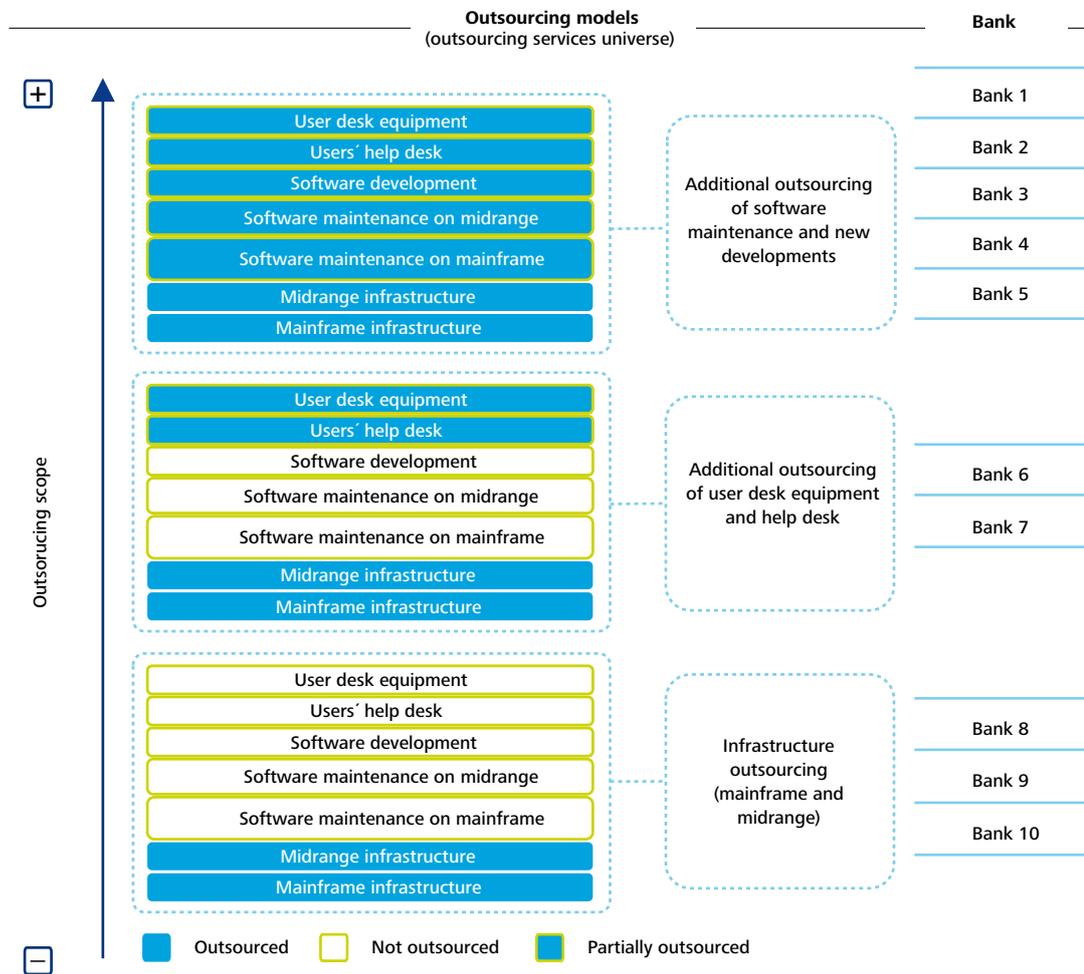
Creating a positive business case to undertake such a transformation is notoriously difficult. The costs of core replacement are significant and crystallise well ahead of the benefits. The latter are likely to accrue over a long period of time, typically longer than most banks' planning horizons of one-to-three years. In addition, while IT cost savings are relatively easy to model and to track, our experience has shown that IT cost reduction alone is highly unlikely to give a fast enough payback time. Operational cost reduction and revenue synergies from a more flexible infrastructure are often the key driver of a positive case. When combined with the argument to reform IT to make the business more customer-centric, the case gets stronger, as we have outlined.

Moreover, changing a core banking system is a major endeavour for any organisation. It can be considered as a 'once in a lifetime' investment. There are many examples of replacement programmes that have massively exceeded their original budgets and timetables, or failed completely. These tend to overshadow the successful programmes. Making incremental changes to legacy platforms can be the path of least resistance.

And the sector has had some unhappy experiences with outsourcing, which is already a significant phenomenon. Banks spend on average \$100bn per year on IT outsourcing contracts.¹⁸ But their experience has been patchy, with some high-profile outsourcing deals brought back in-house. For example, in the UK a decade ago, Bank of Scotland and Halifax terminated huge deals with their providers. In the US, JP Morgan terminated a \$5bn deal, though some of this was later outsourced again.

However, there are signs that small and medium-sized banks have come to the strategic decision that outsourcing core systems makes sense. Most Spanish banks are outsourcing their IT platforms. See figure 11.

Figure 11. IT platform outsourcing models in Spanish banks



Source: Deloitte analysis

In the UK, Sainsbury's Bank will be processed by FIS. TSB will continue to operate on platforms owned and run by its former parent, Lloyds Banking Group.

We believe that a dearth of process outsourcers, apart from in credit-card processing, may also be partly to blame for banks' reluctance to change. One option is that banks could cooperate to set up processors.

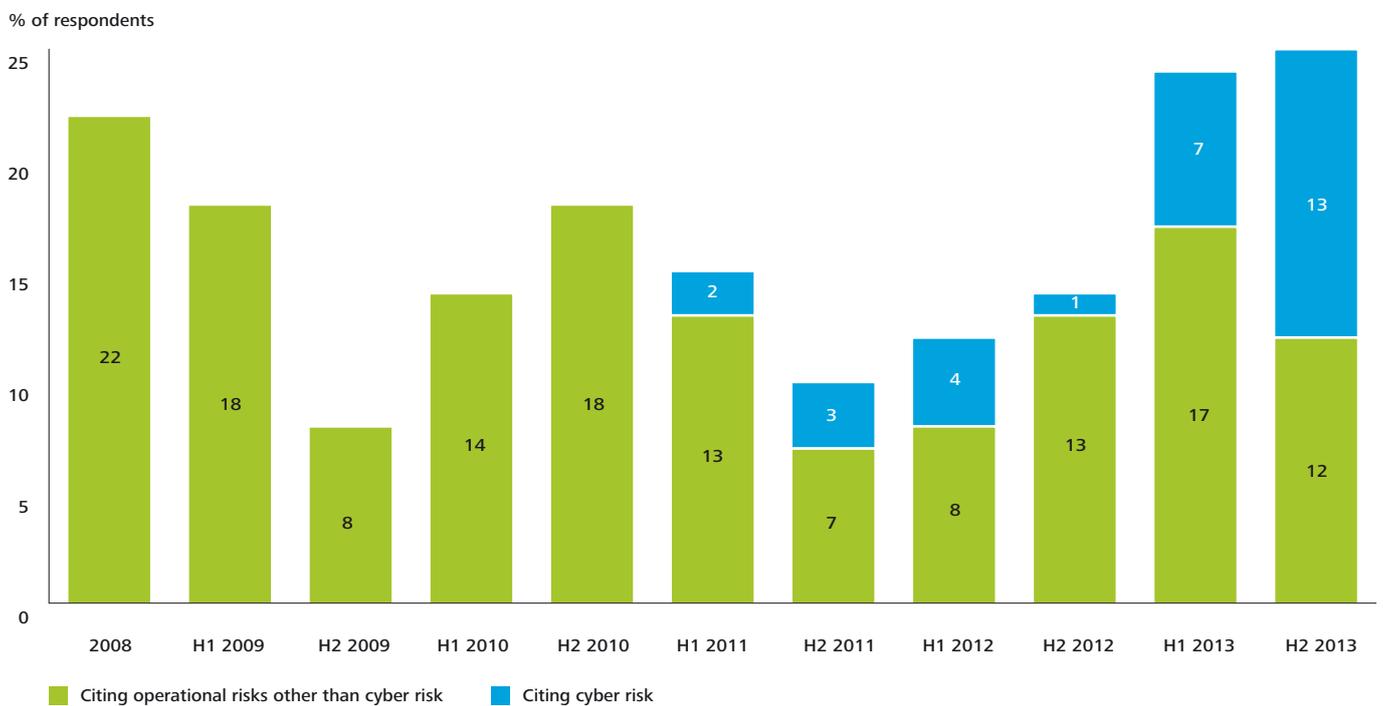
If the long-term picture is of a shrinking revenue base, then it is up to executives to convince investors that costs, too, will have to shrink, and that this will require a different operating model. Investors should, in turn, adjust their expectations of shareholder return.

The threat of more ATM and website outages – and associated regulatory and customer displeasure – should help senior bankers make the case.

In the UK, for example, the FCA, the Prudential Regulation Authority and the Bank of England are conducting a joint review into the resilience of banks' systems.¹⁹

Some of these outages are due simply to elderly, creaking systems breaking down. Others are due to cybercrime, which is rising as a perceived threat among bankers. See figure 12.

Figure 12. The perception of cyber risk



Source: Bank of England Systemic Risk Surveys and Bank calculations

Note: Respondents who cited operation risk at least once, when asked to list the five risks that would have the greatest impact on the UK Financial System were they to materialise. The composition of risks shown is based on the proportion of responses that explicitly cited cyber risk or a closely related term. The Systemic Risk Survey is generally completed by executives responsible for firms' risk management activities.

Regulators are posing questions about banks' IT resilience in the face of cybercrime. Technology is the first of seven "forward-looking areas of focus" for the UK's FCA in 2014, for example. There are three reasons for the increased concern. First, the volume and, therefore, asset value of customer data now collected and stored is far greater than it was a decade ago.

Second, new channels and the rise in transactions increase the points of entry. Finally, banks' laudable efforts to integrate channels means that entire systems can be vulnerable in the event of an attack on one part of the bank.

The associated reputational, regulatory and litigation costs cannot be overlooked when the business case for change is assessed.

Conclusion

While significant downside risks remain, it appears that most European banks are out of the mortal danger faced during the financial crisis. Indeed, pockets of strong profitability are emerging in retail banking, as existing loans mature and state-subsidised funding allow banks both to regain lending capacity and to roll off more expensive funding gathered under stress.

In the short- to medium-term, profitability will remain challenged by both cyclical and structural factors. Returns on equity are languishing owing to historic loan losses, largely in CRE, and fines for past misdemeanours. Re-regulation – specifically higher regulatory capital and leverage ratios – is reducing returns more permanently.

(a) Riding the cycle is not enough

Many banks are relying on growing their loan books, while widening margins on deposits as rates rise, to offset the challenges to profitability.

Such balance sheet optimisation may deliver short-term profits. However, we believe that it is risky – particularly for smaller and mid-sized banks – to rely on a cyclical upswing in the longer term. Yet this is precisely what many banks are doing. To hit profit targets, many UK banks, for example, are relying on healthy retail asset growth (primarily mortgages) at spreads over deposit pricing that are well in excess of pre-crisis levels. They seem to be hoping that if competition in the mortgage market does increase, the impact will be offset by a softening of deposit pricing. Banks have plenty of funding capacity with CRE loans rolling off, and corporate and investment banking shrinking. So, the argument goes, they will not need to compete so hard for deposits.

This strategy relies on incumbents retaining a controlling share of customer deposits. That looks an over-optimistic assumption. The more likely outcome is that the intense competition in lump-sum savings and mortgages from new entrants witnessed in the pre-crisis years will return. A new, stronger breed of competitor will not be so easily squeezed out by incumbents, cross-subsidised by higher-margin products or less favourable back-book pricing, even were regulators to allow it. Nor will banks be able to gear up sufficiently to squeeze economic returns from low margins, as they did in the past.

(b) Radical cost-cutting required

Our view is that maintaining returns above the cost of equity over the longer term requires a dramatic change in the way incumbent banks operate. They must slash costs. As competition from alternative sources of funding intensifies, it is simply not credible for banks to anticipate healthy returns while also allowing for the huge costs of operating inflexible IT systems built on 1970s technology.

Banks will need to re-invent their technology infrastructure. We believe this should involve an even greater use of third party providers than in the past.

Moreover, banks will no longer be able to operate such large branch networks, with many branches operating at low levels of productivity.

(c) New customer proposition required

Cost-cutting on its own is not enough. Banks will not survive off their back-books alone, and the customer value proposition will need to be refreshed for an era where control of a physical branch network no longer guarantees a sustainable level of new business. Alongside improving the economics of capturing new customer relationships through digital channels, banks will need to find better ways of maintaining customer lifetime value. Regulation is limiting banks' ability to incentivise branch staff to sell products that generate the highest return for the bank. New technologies, such as powerful smartphones, ubiquitous broadband, faster processing speeds and bigger memories, mean customers will be able to turn easily to independent aggregators to optimise their financial product holdings across a range of providers.

Banks must respond to this by improving their core relationship offering. In principle, they could use the data that sits behind a current account to add real value to customers by optimising spending patterns, delivering tailored reward programmes and even seeking out discounts on customers' behalf, like the aggregators.

But banks must also be realistic about where they will be able to command a relationship premium. It seems increasingly unlikely that this will be in standard retail banking propositions, like mortgages and savings.

Banks should focus on small and medium-sized enterprise banking, where there is a far wider opportunity to offer value-added services to generate real loyalty, as well as healthy fee income.

Banks will also need to offer something more compelling around wealth management, using new technology to overcome the considerable barriers to profitability that regulation in this area has put in place.

Of course, the timing of these developments is by no means clear. In the meantime, banks must be alert to short-term opportunities that could provide a war chest to tackle the challenges ahead. The key is not to confuse opportunistic tactics for strategy. Real change is coming, and the winners will be those best able to use tactical optimisation within a long-term strategy that shapes a business fit for a very different competitive environment in the years ahead.

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