Bridging the Profitability Gap
Executive Summary

For a period spanning almost 3 decades, the banking sector has enjoyed extremely high profitability. In the period 1980-2007, banks earned an average annual Return on Equity (RoE) of 16% - high both in comparison to historical levels and relative to other industries. This elevated level of RoE was facilitated and sustained by three main factors: deregulation, strong global macro-economic conditions and high leverage.

However, owing to a number of structural changes in the industry, global banking RoE has now been reset to materially lower levels; essentially, a profitability gap has opened up. There are four main structural changes that have driven down RoE: tougher regulation, especially in the form of higher capital requirements; changing customer behaviour, putting pressure on pricing at the same time as raising cost to serve; increased funding costs, stemming in particular from a relative shrinkage in the wholesale lending market; and, more intense competition arising chiefly from new market entrants.

In this paper, we set out how core banking renewal could provide the levers for banks to grow RoE. Since modern core banking systems are integrated, flexible and scalable, they can help banks to improve RoE in four key ways. Firstly, by providing complete and real-time information, they can help banks to improve the level of cross-selling and lower the level of non-performing loans. Secondly, by improving the level of automation and straight-through-processing, they can help banks to reduce operational and IT costs. Thirdly, the inherent scalability of the systems allows banks to extract economies of scale from organic growth and acquisitions, particularly in operations, processing and IT. Lastly, the flexibility of the systems allows banks to adapt very quickly to changing market conditions such as launching new products.

We also attempt to quantify the possible impact on industry profitability from core banking renewal. We have conducted analysis on the relative profitability of banks running core banking systems compared to banks running legacy applications. This analysis, based on a large data sample across multiple years, illustrates that banks running modern, third party core systems enjoy significantly better profitability metrics. And if we extrapolate this differential in profitability, we estimate that core replacement could reduce the profitability gap by between 25% and 60%.

It is imperative for banks to act quickly on core replacement. The case for core banking renewal is evidently compelling, but its benefits have been known for a long time and yet relatively few banks have undergone core replacement. The reason is two-fold: on the one hand, the programmes can be expensive and risky and, on the other, banks have been able to defer action. In respect of the latter, the regulatory and operating environment has not punished banks for inefficiency, but this is now changing. In developed markets, the absence of historical rates of revenue growth will expose structural inefficiency, while in the emerging world, more highly contested markets will force banks to raise the level of customer service at the same time as lowering pricing.

Not only have core banking systems matured significantly over recent years, but so too have implementation methodologies and there are many large system integrators operating in the sector today. In the last section of this paper, we mine our experience from a large number of core banking implementations to share a set of best practices to maximise return and minimise risks from core renewal projects.
For a period spanning almost 3 decades, the average RoE across the global banking industry was around 16% per year. However, the financial crisis of 2008 has ushered in a period of re-regulation which, together with changes in bank funding, competition and customer behaviour, has reset industry profitability to much lower levels.

1980-2007: High Sustained RoE, Averaging 16%
Between 1980 and 2007, banks enjoyed high returns on equity; better, in fact, than at any other time.1 Such high levels of return were made possible by the confluence of several factors:

- **Government Deregulation** - across many of the major markets (e.g. the Thatcher government’s “Big Bang” reforms in the UK in 1986, the repealing of the Glass-Steagall Act in the US in 1999, etc.) which allowed banks to diversify outside of traditional retail and corporate banking into businesses and products that offered higher returns (albeit also higher risks)

- **Strong Economic Fundamentals** - for a host of reasons, the global economy enjoyed both below-trend inflation and above-trend GDP growth. During the period, world economic growth averaged 3.0% compared to the pre-war average of 1.7% and global inflation averaged 2.6%

- **High Leverage** - not only did regulators permit this, but wholesale markets were prepared to provide the funds and at very low rates of interest. During the period, global assets as percentage of GDP rose from 94% in 1980 to over 160% in 2007.

2008 And Beyond: Profitability Has Been Reset
Since 2008, the structure of the banking industry has been changed such that RoE has been reset to materially lower levels.

The Financial Crisis: In 2008, the financial crisis hit, triggering - in the first instance - massive write-downs on financial instruments where liquidity had evaporated and which were rendered worthless, followed by a squeeze on funding and then, via the real economy, further write-downs on corporate and domestic (especially housing) loans. Between the third quarter of 2007 and the end of 2009, banks had written down the value of their assets by approximately USD1.5 trillion (equivalent to 2.4% of global GDP). Given this context, it is not surprising that global banking RoE fell precipitously, from 18% in 2006 to just 4% in 2008.

The Aftermath Of The Financial Crisis: History is likely to judge favourably governments’ response to the financial crisis (probably much more so than its response to the later sovereign debt crisis) in that it was fast, coordinated and effective. Governments took stakes in banks (nationalising banks in some instances7) where these banks could not raise new capital; they took illiquid assets onto their balance sheets8; and they encouraged central banks to provide cheap sources of short term funding as well as boost liquidity by printing money to buy government debt. As a consequence, the financial crisis was short-lived and by 2010, global RoE levels had recovered somewhat – to around 10%.

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**Fig 1**

![Global Banking Return on Equity (%)](image)

**Sources**

1 Between 1920 and 1970 the return on equity of UK Banks averaged below 10% with very low volatility, the trend was similar globally. (Source: Bank for International Settlements, Andrew G Haldane: Banking on the state).

2 Principal reasons included advances in information technology, which facilitated above-trend productivity growth and faster globalisation of production, and the rapid industrialisation of emerging economies, especially China.


4 Angus Maddison, Monitoring the World Economy. Real GDP growth averaged 1.0% from 1820-1870, 2.1 % from 1870 to 1913 and 1.9% from 1914-1950, giving an overall average of 1.7%.


6 IMF Global Financial Stability Report, April 2010: Between 2007 and end of 2009 $1.5 trillion in bank writedowns had been realised.

7 Examples of banks nationalised (partly or fully) include Northern Rock, Royal Bank of Scotland and HBOS-Lloyds-TSB in the UK, Anglo Irish Bank in Ireland, the Dutch activities of Fortis in Holland, and Iceland’s largest commercial banks. The US government’s support of Citigroup, Federal Home Loan Mortgage Corporation and Federal National Mortgage Association are considered by many to have been forms of nationalisation.

8 Examples of illiquid/toxic assets taken on to government balance sheets include: The Swiss National Bank taking USD 38.7 billion of toxic assets from UBS, and the United States Treasury Department’s $700 billion Troubled Asset Relief Program (TARP) – although this programme was later changed and the funds were used to inject capital into troubled banks.
Nonetheless, despite access to cheap lines of credit, improving economic conditions and the non-cash boost of lower loan provisioning, RoE levels peaked at 10%. Part of the explanation lies in the fact that the global economy enjoyed a mini-bounce, rather than entering into a new, full expansionary cycle. However, the more fundamental explanation is that banking has changed and, for the following reasons, RoE is likely to remain depressed vis-à-vis pre-crisis levels:

**New Capital Requirements:** Governments and regulators want to make banks safer. Arguably the simplest and most effective way to do this is to require them to hold more capital relative to assets as a buffer against any future losses. Accordingly, new and tougher rules on capital are being introduced. Globally, the Basel III accord will require banks to hold tier 1 capital equal to 6% of risk weighted assets (plus a 2.5% capital surcharge) and banks deemed to be “systemically important” will be subject to a further surcharge. To meet the requirements (and often stricter local rules such as in the Eurozone, UK and Switzerland) banks will need either to raise significant levels of new Tier 1 capital (about EUR1.1 trillion for European banks and USD870 billion for US banks) or they will need to shrink significantly the level of risk-weighted assets or, most likely, a combination of both. Regardless of how banks comply (growing the denominator or shrinking the numerator) the effect on global RoE will be sizeable. McKinsey estimates that just the effect of complying with Basel III will lower long run RoE by 4.0 percentage points in Europe and 3.0 points in the US.

**Changing Customer Behaviour:** Customers have become more demanding, more savvy and less loyal, pushing up their cost to serve at the same time as eroding banks’ pricing power and thus, ultimately, lowering RoE.

Customers want to do banking on their terms, across their preferred channels and now, given heightened competition, banks are ceding to these demands. Like other retailers, banks are opening for longer and offering services over more channels. This is making it more expensive to serve customers.

Customers have access to more information than in the past. The advent of the internet and, more particularly, price comparison sites has made product pricing in banking very transparent (although fees are still somewhat opaque). Thus, customers are able to shop around easily for the best deals, increasing demand elasticity.

And, compared to historical levels, customers really are shopping around. For instance, in 2011, US customers had relationships with on average 1.9 banks compared to an average of 1.6 banks in 2010: that is, customers are taking products with multiple banks in pursuit of the best deals. Similarly, customers are now beginning to switch banks, dissatisfied either with prices or the level of service: in 2011, 9% of US banking customers switched banks compared to 8% in 2010. Furthermore, the actions of consumers in this regard have to some extent been fostered by regulators in developed countries who have sought to introduce greater price transparency at the same time as reducing the barriers to switching accounts.

**Higher Funding Costs:** The wholesale funding market is shrinking in relative terms, affecting some banking markets more than others, but overall pushing up funding costs as competition for deposits and other forms of funding intensifies. As illustrated, Fig.2, the proportion of European bank funding coming from the interbank market has been falling for a protracted period of time. It is thus a secular, rather than a temporary phenomenon, although the rate of decline has accelerated with the onset of the banking (and sovereign debt) crisis. If funding costs are rising and banks are not able to pass on the costs (see above) then Net Interest Margins (NIMs) come under pressure – leading to lower RoE.

![Fig.2](image-url)

**More Intense Competition:** The competitive landscape is changing dramatically. Incumbent banks face competition on many fronts. Firstly, there is competition from new banks, such as Metro Bank in the UK. Secondly, there is competition from existing banks setting up new operations: for example, developed world banks expanding to offer services in emerging markets or retail banks pushing into mass affluent private banking services. Thirdly, there is competition from non-banks offering banking services, in particular retail companies providing retail banking products and services, such as Wal-Mart in the US. Lastly, there is the phenomenon of consumers bypassing traditional financial institutions altogether, using, for instance, a peer-to-peer intermediary to borrow directly from each other or a non-bank intermediary like PayPal to make payments to each other.

Whatever the form of additional competition, however, the outcome is the same. More competition in a market allows customers more choice and, in turn, causes prices to fall. In banking, this means that net interest margins will come under pressure, causing aggregate levels of RoE to fall.

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**Sources**


11 JD Power and Associates 2011 Retail Bank Study

12 JD Power and Associates 2011 Retail Bank Study

13 Consider, for instance, the actions being taken by the UK government to allow individuals and small businesses to switch to another bank within seven days and for all the direct debits and credits to be transferred for them at no cost.

14 Peer to peer lending is primarily a retail banking phenomenon but also exists for corporate customers. Examples include Zopa, Prosper and Kiva.
How Modern Core Banking Software Can Address the Profitability Gap

The Industry Needs A Structural Answer
Operating as usual will not bridge the profitability gap. The responses we have seen from banks so far, which include staff reductions, hiring freezes and tighter procurement processes, are the usual responses to a cyclical economic downturn and do not address the root cause of high costs. They will likely produce a modest improvement in cost to income (and by extension RoE), but as soon as macroeconomic conditions improve, these costs will find their way back into the business. In some cases, there will even be a short term increase as banks catch-up, for example, undertaking delayed capex projects. Any improvements in cost to income (and RoE) are thus unlikely to be sustainable.

Instead, the industry needs a structural answer to a structural problem. For the reasons set out in the previous section, profitability in banking has been reduced to a structurally lower base. Banks need to improve revenue generation per asset and lower cost to income in a systematic way that will yield sustainable improvements in RoE across the business cycles; a structural solution is required.

Modern Core Banking Systems Give Banks Four Key Levers To Raise RoE
In this section, we set out the four key ways in which banks can use modern core banking technology to raise RoE.

Enabling Banks To Move Into More Profitable Markets And Segments
An important means of improving RoE is for a bank to reposition a greater part of its business in segments and markets that generate higher margins. Clearly, if all banks move into the same segments and markets in pursuit of higher returns then, all else being equal, margins will fall. So the key is to reposition the bank’s operations effectively and quickly.

A modern core banking system can help on both counts. The key to entering a new market successfully is being able to differentiate products and services. Modern systems can enable this by affording the complete view of customers needed to understand what products and features will appeal, and the flexibility for banks to be able to tailor products and services accordingly. Modern core banking systems permit a bank to launch new products by constructing them from existing components which speeds time to market. In addition, they enable banks to rapidly open new branches and to launch new channels, such as mobile, while maintaining consistency to enable a true multi-channel experience.

As a recent example, Temenos was able to help Credit Agricole launch a new private banking concept, called BforBank. The attraction of private banking is clear: it has high margins; it offers a rich source of deposits; and, much of the income is fee-based (higher margin and generally not tying up bank capital). In this case, not only was Credit Agricole able to launch this new bank quickly, in less than a year (with the system implementation taking just 6 months), but BforBank has leveraged technology to successfully differentiate its offering. The bank provides very rich, value added and interactive content like comparison tools, product simulators and expert videos which enable customers to become their own private bankers. And, consequently, BforBank is enjoying notable success: in its first year, it attracted on average more than €7m a day in new deposits.

Enabling Banks To Raise Asset Yield Within Existing Business
In an era of higher capital requirements, raising asset yield (without introducing higher risks) is an important route to higher returns. This can be achieved in two main ways: managing risk better, such that a bank takes lower provisions against its assets (improving per asset profitability) and by selling more to existing customers, since the marginal cost to capture and cost to serve is lowered with every additional product taken. However, increasing asset yield is not easy. In a competitive environment, it is necessary to optimise every element of operations to enable this. It requires a bank, amongst other things, to have complete, rich and real-time customer and risk data or, in other words, a single view of customer and credit risk. A modern core banking system on its own will not raise asset yield, but the information it provides, and the ability to provide it in real time is a necessary precondition, and is therefore essential to full optimisation of this lever.

Techcombank, the fastest-growing and most profitable bank in Vietnam, is an almost textbook example of how to raise asset yield within an existing business. By being first to market for many new products and services and by being able to tailor products and services according to individual profitability, Techcombank has engendered very high levels of customer satisfaction that, in turn, have made possible its above-average NIMs (Fig.3). Furthermore, Techcombank’s sophisticated credit scoring techniques, which take into account amongst other things individual customer exposure, have allowed it to reduce its level of non-performing loans (NPLs) despite extremely rapid asset growth. In total, Techcombank’s profitability per customer is rising by on average 25% a year, contributing to a compound annual growth in operating profit of 82% since T24 was introduced in 2003.15

Fig 3
Techcombank Has Increased Deposits by a CAGR of 70% Without Having to Sacrifice NIM

Sources
15 A detailed case study on Techcombank can be downloaded from the Temenos website: www.temenos.com/profit.
Enabling Banks To Cut Costs Sustainably

Cutting costs is easy. Cutting costs in a way that is both sustainable and supportive of a bank’s future growth prospects is more challenging. It requires streamlining and automation of processes, which enables the bank to optimise their operations rather than simply paring them back.

Replacing legacy banking applications with a modern third-party system is the principal means of extracting these cost reductions, while also rendering a bank more flexible and agile to exploit future growth opportunities.

In our experience, the most significant cost savings typically arise from reductions in the number of, and productivity increases from, IT and back office employees (through greater automation and fewer errors) and from hardware and software maintenance consolidation. In addition, further and ongoing efficiencies should also be achievable from optimising operations overall, for example, by reducing the time it takes to introduce new products.

To give an indication of the level of immediate savings that a bank might enjoy through core replacement, consider the example of Schroder’s Private Banking. In 2006, it centralised its IT and back office functions into one hub using Temenos T24 and in the process was able to cut its total operating costs by one third. Roughly 60% of the cost saving came from a reduction in headcount, with the remainder coming from lower infrastructure costs like IT and rent. As regards the IT cost savings achieved, the bank was able, for instance, to reduce its number of software applications from 32 to 12 and its number of datacentres from 6 to 2 as part of this exercise.

Enabling Banks To Extract Economies Of Scale

Modern technology is essential for banks to be able to realise the scale economies that should arise from growth, both organic and inorganic, and so deliver higher productivity and, by extension, higher RoE.

Nonetheless, banks have a very poor record of extracting economies of scale from IT. Various studies have illustrated that increases in IT spending by banks have failed to yield correspondingly higher levels of productivity improvements and, in fact, for protracted periods of time, have produced even negative returns on investment. We suggest that this phenomenon of diminishing and negative productivity returns owes to the nature of IT systems that most large banks run today: complex, siloed, badly documented and with significant manual workarounds which preclude meaningful productivity gains.

Having an integrated and scalable technology infrastructure allows a bank to add more and more customer and processing volume without experiencing a commensurate increase in hardware, software or labour costs, thus reducing its IT costs relative to income. Take the example of Bank of Shanghai, currently one of the largest volume users of T24, which is adding around 700,000 new retail and corporate customers a year on its IT platform. Bank of Shanghai’s productivity gains have been impressive, its ratio of IT costs to total assets, for instance, is 44% lower than its domestic peers.

The same failure of banks to generate economies of scale from organic growth is also evident in M&A transactions. In a recent study, we found that a clear majority of banking M&A transactions destroy shareholder value. The reason is the same as above: margins post transaction fail to improve because banks fail to deliver on cost synergies, particularly in the areas of IT and back office spending. Our conclusion, again, is that this is because legacy systems make these synergies all but impossible to realise.

Where banks operate modern systems, their record on value creation through M&A is demonstrably superior. Take EFG Bank, for example: a Temenos customer since 1993, the bank has made 24 acquisitions since that time - on top of rapid organic growth. Nonetheless, since it has successfully integrated the IT and back office infrastructures of all acquisitions (and new locations) onto its global platform, the bank spends less than 6% of total costs on IT; roughly one-third of the average for European private banks.

Sources
16 A detailed case study on Schroder’s Private Bank’s implementation of T24 is downloadable from the Temenos website: www.temenos.com/profit
18 A detailed case study assessing the impact of T24 at Bank of Shanghai is downloadable from the Temenos website: www.temenos.com/profit
19 We undertook a study of the 20 largest banking M&A transactions between 1995 and 2005, which we intend to publish shortly
20 We develop and illustrate this point much more profoundly in our report.
Banks Running Modern Core Banking Systems Have Taken Advantage of Improved Profitability

For the last 3 years, we have used information from The Banker database to carry out analysis regarding the relative performance of banks using modern core banking systems compared to banks using legacy software. In short, we use a third-party source to identify the list of banks using software from the biggest vendors in the marketplace and then we compare the average values for these banks against all others.

What this analysis shows is that banks running modern core banking systems have materially better profitability metrics. Over the last 3 years, banks using third-party banking applications have enjoyed on average a 25% higher return on assets, a 37% higher return on capital and a 7.4% lower cost to income ratio than banks running legacy applications. What is more, this differential in profitability holds not just on average over the three 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.

The differential in performance between Temenos customers and all other banks is even greater. Over the last 3 years, Temenos customers have enjoyed on average a 30% higher return on assets, a 46% higher return on capital and an 8.5 point lower cost to income ratio than banks running legacy applications. Compared to banks running other third-party banking applications, this difference is smaller but still significant: over the last three years, Temenos customers have demonstrated a 9% higher return on assets, an 11% higher return on capital and a 1.8 point lower cost to income. Moreover, in common with the analysis on the full population of banks running third-party systems, the superior performance of Temenos customers exists across all 3 years, across all regions and even across different segments: that is to say, normalising for any inherent biases in the Temenos customer (towards, say, emerging market banks or private banks), we observe that this correlation still holds.

Thus, we believe that this analysis offers highly compelling support for adopting third-party core banking software as a means of improving profitability. Through our research, we have demonstrated a strong and sustained correlation between third-party software usage and superior performance. In short, we position that using third-party systems is a significant factor in superior bank performance and using core banking from Temenos can drive even more pronounced outperformance.

The correlation we have observed between packaged software usage and higher profitability in banking also holds across industries. In Fig 5, we show the strong inverse correlation (minus 84%) that exists between industries’ relative IT expenditure and their relative spending on packaged software. In other words, the more an industry spends on packaged software relative to in-house development the lower its level of IT spending relative to other costs (and, all else being equal, the higher its profitability). Anticipating the objection that, since banking is a highly IT-intensive industry (where products and services contain high levels of information and use of technology is pervasive), banking will always have higher relative IT spending, we include the average IT spending figures for Temenos customers. While it is unrealistic given the degree of IT intensity to assume that banks’ relative IT spending could ever reach the levels of, say, the industrial goods industry, we would point out that higher relative IT intensity in an industry should give greater scope for extracting IT economies of scale. As we have argued above, this has not happened largely because of the antiquated systems in use. In the case of Temenos customers, their IT spending (at 5.7% of total costs) is lower than the cross-industry average.

Sources
21 Our third-party source for the different vendor installed bases is the IBS BOSS guide, which we acknowledge may not be completely up-to-date or accurate. For Temenos customers, we have used the Temenos customer list. We have made the calculations based on the customers of the following vendors, who we believe to be the biggest by value of sales and number of on-premise installations: Temenos, Oracle, Infosys, TCS, Misys, SAP and Avaloq.
22 In fact, we compare the performance of banks running systems from the top 7 vendors against all others, that is to say that the comparative population of banks is likely to be mostly banks running legacy applications but will also include a small number of banks running applications from other third-party vendors.
23 We conducted an extensive survey of our customers in 2010 in order to ascertain their ratio of IT costs to total costs. We did not, however, ask customers to provide a breakdown of their spending on packaged software relative to total software spending and so we have estimated the percentage to be around 60% in figure 5.

Fig.5 Purchased Software Penetration vs. IT Spend As % Of Costs

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To What Extent Could Core System Replacement Help Bridge The Profitability Gap?

In this section, we quantify the profitability gap and apply the analysis above, regarding the higher profitability of banks running modern core systems, to try to determine the extent to which core replacement could help bridge the profitability gap.

As discussed above, our contention is that the gap between the level of RoE in 2010, when the banking sector was riding a wave of cheap central bank liquidity and improved economic fundamentals, and the pre-crisis average of 16% represents the structural profitability gap that has arisen from structural changes in the industry, notably re-regulation, since the onset of the financial crisis.

We can quantify this profitability gap. RoE in 2010 was 10% compared to the pre-crisis average of 16%, that is to say, the gap in RoE equates to six percentage points\(^24\). The level of equity held by banks at the end of 2010 was approximately USD5.4 trillion\(^25\). Applying 6 percentage points to this equity figure implies that banks’ net income would need to rise by USD308bn\(^26\) globally for pre-crisis RoE levels to be restored.

Extrapolating the quantitative analysis above, we postulate that if all banks globally adopted modern core banking systems, the profitability gap could be reduced by between 25%-60%. If banks adopted modern core systems from the major vendors in the same proportion to which they have historically, we suggest that the profitability gap would reduce by around 25%\(^27\) and, if all banks globally adopted modern core banking software from Temenos, they would generate $180 billion of higher annual post-tax profits, reducing the gap by 60%\(^28\) (Fig.6).

<table>
<thead>
<tr>
<th>Third party banking applications</th>
<th>Temenos</th>
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<tbody>
<tr>
<td>Pre-tax ROE</td>
<td>14.28%</td>
</tr>
<tr>
<td>Post tax ROE (assume 20% tax rate)</td>
<td>11.4%</td>
</tr>
<tr>
<td>2010 average ROE</td>
<td>10.0%</td>
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<tr>
<td>Core systems uplift to ROE</td>
<td>1.4%</td>
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<tr>
<td>As % of the 5.7% profit gap</td>
<td>25%</td>
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</tbody>
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Source: Thomson Reuters, Temenos and Deloitte estimates

Sources
24 The pre-crisis average was actually is 15.7%, so in our calculations we use 5.7%, not 6%
25 This figure represents the total Tier 1 capital of all banks in The Banker’s Top 1000 World Banks 2011 (for the year ending 31 December 2010). Even though this list captures only a small subset of banks, it captures the largest and we estimate that this equity figure constitutes approximately 90%+ of the total for all banks
26 Calculated as: Profitability multiplied by total equity (i.e. 5.7% multiplied by USD5.4 trillion)
27 Based on our analysis in 2010, banks running third-party core banking systems had a ratio of pre-tax profit to equity of 14.28%. To arrive at a RoE number, we have assumed a tax rate of 20%, giving 11.4% - i.e. 1.4 percentage points higher than all banks. Expressed as a proportion of the 5.7% gap, this is 25%.
28 Based on our analysis in 2010, banks running Temenos core banking systems had a ratio of pre-tax profit to equity of 16.6%. To arrive at a RoE number, we have assumed a tax rate of 20%, giving 13.3% - i.e. 3.3 percentage points higher than all banks. Expressed as a proportion of the 5.7% gap, this is 58%, which we round up to 60%.
Why Banks Need To Act Now

The need to replace core systems in order to raise RoE and restore the banking industry to historical profitability levels has been made clear. However, what is still to demonstrate is the danger of excessive procrastination.

Even though core replacement has become more urgent in the context of lower post-crisis profitability, the advantages of taking modern core systems have long been espoused and yet relatively few banks have actually undergone core replacement\textsuperscript{29}. Part of the explanation lies in the high real and perceived risks of undertaking this kind of transformative IT project (which are discussed in the next section), but part of the explanation also lies in the fact that banks have not needed to act. In the developed world, up until very recently, the economic, competitive and regulatory environments have been sufficiently benign as not to penalise banks too seriously for inefficiency: essentially, more income could always be found to cover up for structurally high costs. In the developing world, a buoyant backdrop has allowed practically all banks to enjoy high growth, regardless of operational efficiency and agility. However, the picture is changing and in both cases we estimate that delaying system replacement will begin to have much more profound negative consequences.

Developed World Banks

Developed world banks are facing slower income growth prospects due to increased competition and reduced customer loyalty. However, their cost bases remain structurally high and, since mainly composed of staff costs, are likely to grow by at least the rate of inflation. In fact, cost bases are likely to grow even faster than this given the need to invest to meet heightened customer demands, to protect market share against more intense competition and to provide banking services over an increasing number of channels. Thus, it is quite likely, not to say certain, that costs will rise faster than revenues over the coming years for banks – in the absence of technology modernisation.

In the chart, Fig.7, we demonstrate how taking the industry’s current starting point the compounding effect of faster cost than income growth could render unprofitable developed world banks as soon as 10 years from now. And since, on average in our experience, it takes 2-4 years to ready an organisation for, and implement, core system change, it is incumbent on banks to move immediately.

Emerging World Banks

Emerging world banks are not restricted by the same lack of growth opportunities as their counterparts in the developed world but, nonetheless, are also constrained by their legacy core banking systems. In short, banks can no longer rely on the phenomenon of a rising tide lifting all boats.

In the emerging world, banking assets are expected to grow at a compound rate of 9% through to 2030, which would imply over $40 trillion of asset growth in absolute terms\textsuperscript{31}. The attractiveness of these markets will attract new entrants, such as start-up banks, non-banks and banks from overseas. This will force incumbent banks to improve customer service at the same time as lowering pricing.

Take a concrete example: the sizeable opportunity arising from providing banking services to the large unbanked population in emerging markets. It is estimated that 2.5 billion people, half the world’s population, are unbanked, and the vast majority of these people are in the developing world\textsuperscript{32}. The provision of basic banking services to this large unbanked population is one of the major factors underpinning asset growth in the emerging world. Thus, exploiting this secular growth trend – banking the unbanked, so to speak – is key to enduring success for emerging market banks.

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\textsuperscript{29} Based on recent industry analyst data, still only 18% of banks’ licensing and maintenance spending on core systems is spent with third-party vendors like Temenos

\textsuperscript{30} For our starting point, we have taken the present cost to income ratio of developed world banks from The Banker Top 1000 banks and modelled a 1% growth in income compared to a 4% growth in costs.

\textsuperscript{31} PWC. “Banking in 2050”

\textsuperscript{32} Financial Access Initiative: “Half the World is Unbanked”
However, what prohibits banks from taking fuller advantage of this opportunity is not demand for services, but the cost of providing these services. The issue for the unbanked population is the cost of banking services relative to their income: that is, they would open a bank account today if cheap enough, but for incumbent banks it is uneconomical to provide services. Because banks are running infrastructure that is inherently lacking in scalability and flexibility, the marginal cost to serve customers is not reducing as it should, making these customers who require (today) only the most basic services too expensive to serve.

However, if incumbent banks do not seize this opportunity, someone will and the opportunity could be lost forever. Given the massive potential economies of scale in serving such a large untapped market of customers who require largely homogenised services, the opportunity will attract new entrants. Any new entrant would likely buy one of the many core banking packages available and so be unencumbered by the legacy systems that make serving this market unprofitable today. Banks have an urgency to act now and win as many lower income customers in emerging markets as possible before new entrants begin to capture these customers.

As an illustration, consider the example of M-Pesa in Kenya. In 2007, it launched a set of simple and inexpensive banking services such as money transfers, bill payments, deposits and withdrawals, which could be originated over a mobile handset. Since then, its subscriber numbers have grown to 14m (Fig.8), which equates to approximately 68% of the adult population.

![Fig.8](image-url)

MPesa Subscriber Numbers Since 2007 (LHS) Expressed As % of Adult Population (RHS)

Source: Safaricom, Unicef
As discussed banks face a number of fundamental challenges:

- A massive regulatory burden that is driving the need to reduce costs, raise capital and improve risk management
- Increasing customer expectations such as real-time banking driven by the explosion in the use of smartphones and mobile payments and the rise in the sophistication of corporate cash management
- Competition on price, service levels and product features from those banks that have already rationalised their platforms or new entrants with flexible and low cost platforms
- High operational costs and operating risk driven by the use of multiple legacy platforms, often in a range of product silos, with poor automation and major challenges in providing an operational single customer view

Nonetheless, banks are struggling to make the changes to overcome these challenges. The normal obstacle to change inside a bank is the fragility, complexity and high change cost of bank’s IT estates, driven by dozens of different technology platforms, hundreds or thousands of applications and thousands or tens of thousands of interfaces. This results in a number of symptoms illustrated below.

A compelling case has been made in this paper for the need to replace systems, yet relatively few banks have undergone the process. In our view most banks realise that rationalising and replacing their core platforms is probably the only way to effect a fundamental reduction in operating costs and operational risk and enable future business flexibility. However, there are two major challenges to embarking on this journey:

1. Creating a positive business case to undertake such a transformation is notoriously difficult\(^3\), the costs of core replacement are significant and crystallise well ahead of the benefits, which are likely to accrue over a long period of time, typically longer than most banks’ planning horizons of 1-3 years. Cost savings are relatively easy to model and to track and our experience has shown that IT cost reduction alone is highly unlikely to give a fast enough payback time and that operational cost reduction is often the key driver of a positive case. The benefits of core replacement in terms of additional revenue are more difficult to model and measure and cases that are only made positive by such benefits tend to have less credence with decision makers. Alternatively, there may be some fundamental limitation of a bank’s existing platforms (such as the inability to scale further or support real time banking) that means the cost of retaining the existing platforms is prohibitive, although we note that banks typically have great expertise in keeping legacy platforms going.

2. Changing a core banking system is a major endeavour for any organisation and could 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, which tend to overshadow the successful programmes.

\(^3\) A topic explored in the Deloitte white paper Making the case for change: How to create a business case for core banking replacement
Given that personal careers can be at stake, remaining on the path of incremental changes to legacy platforms is usually an easier decision than accepting a replacement is necessary. Below is a list of some of the common reasons why banks’ core banking modernisation programmes fail:

- Lack of business leadership or involvement: many programmes under-invest in business change and programme management and lack effective decision making. This is often because they lack sufficient business involvement or leadership, and often because they have originated out of the IT organisation or only one area of the business. It is not uncommon to see IT organisations being blamed for poor delivery when in fact the right conditions have not been established to enable them to deliver successfully.

- Initial planning and budgeting is too optimistic: in the interests of gaining approval for a replacement programme, to win the platform selection or to win the implementation partner procurement, overly optimistic plans and budgets are often produced by the proponents of a core banking replacement programme, whether by those proponents inside a bank or the third parties bidding to supply the technology or undertake the implementation.

- Poor scope management and governance: programmes often do not manage requirements effectively, often characterised by the number of requirements exploding due to unwillingness by the business to compromise on scope and functionality or to rationalise product offerings in the interests of delivering the programme within budget and on time.

- Complexity: the true complexity of implementing a replacement platform driven by aspects such as the number of interfaces to be built, the number of products to be migrated, the millions of customers and accounts and the number of staff to be trained is often only revealed after the programme has started.

These challenges often come together and recent analyst surveys34 on core banking implementation programmes show that no single reason dominates, which doesn’t surprise us given the complex and all-encompassing nature of such programmes35. Those banks that find themselves part way through a programme where these risks have materialised are in the difficult position where the choice is either to give up and write off the investment or to keep going and spend much more money, often without having a firm guarantee that the programme will have a successful ending.

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**Case Study**

### International Corporate Bank

A number of large banks are rolling out corporate banking businesses around the world, in order to service their international clients and attract new corporate customers in developing markets.

Deloitte and Temenos have been working jointly with one such bank to support its ambitious expansion plans. The bank originally selected Temenos T24 as its core banking platform and implemented this in a global hub to support a number of country branches.

In order to accelerate its expansion into new countries, the bank then asked Deloitte to assist with a review of banking regulations and practices, employment conditions and the corporate banking market in a range of countries and to define a standard operating model for each branch that would provide maximum economies of scale by using global operations and platforms wherever possible.

It became apparent through this review that use of a single global banking hub would not be permissible in countries where regulations required data to be held locally and a hub and spoke model would be required.

We then worked with the bank to define the end-to-end process models and business requirements for a country branch and the architecture for a branch where the banking platform, T24, had to be deployed locally. This gave the bank a detailed description of the operations and systems it had to set up for each new branch and therefore enabled it to adopt a repeatable approach to rolling out a new country branch.

This bank now has branches in a number of countries where previously it did not offer corporate banking services, and is able to service its existing international customers in these locations and attract new local corporate customers.

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**Sources**

34 For example see the IBS Journal - How to Run a Core Banking Project Supplement February 2012 at www.ibsintelligence.com

35 For a general review of IT projects, see Why Your IT Project May Be Riskier Than You Think, Harvard Business Review, September 2011
Best Practices For Core Replacement

• Select a great core banking product
• Find the right partners and get them all aligned
• Define clear business requirements
• Manage scope, with a focus on adopt not adapt
• Design the end-to-end solution with the aim of minimising complexity
• Define quick wins to sustain internal buy-in
• Go step by step
• Strong governance with executive sponsorship
• Deliver smartly and put in place effective communication
• Invest in a good business case and use it
Best practices for core replacement

There is no silver bullet for a successful core banking platform implementation, as it will depend on the characteristics of a bank and its particular context in the market. However, there is now much more experience in undertaking such implementations successfully and in our view there is a set of best practices that should be followed by banks in order to reduce implementation risks.

1. Select A Great Core Banking Product

There is often a heavy focus on functionality during the selection of a new core banking platform. This is, of course, important and something we would regard as a minimum bar for selection. However, there are several areas that need a close examination as poor support for any of them is likely to lead to severe problems during implementation, including excessive customisation. Areas to examine include:

- **Multi-channel architecture** – Support for all existing channels and provision of a general framework for supporting future channels in a manner that minimises rework for each channel and supports cross-channel servicing.

- **360° customer view** – Provision of an operational customer-centric view of product ownership and balances, even for products that are not maintained in the core banking platform itself (e.g. often credit cards), including support for credit risk management and corporate hierarchies and relationships.

- **Product catalogue** – A framework for defining new products and product variants and managing the life cycle of products, providing faster time to market with support for governance around product design, launch and retirement.

- **Integration** – Provision of a consistent integration framework for real time and batch interfaces, ideally driven primarily by configuration of the platform rather than customisation. Specific interfaces such as for payments and finance/GL should be supported out of the box.

- **Management of data** – The ability of the platform to manage huge volumes of data that will be generated as it is used. This should include enabling historical data to be archived and deleted, support for feeding downstream analytics platforms and operational data stores and support for master data management.

- **High availability multi-entity architecture** – The architecture should enable 24x7 operation and a high availability dual site architecture, minimising or avoiding any impact on service due to end of day/end of period processing, supporting real time straight through processing, and supporting multiple entities, jurisdictions, countries, currencies and time zones.

- **Product architecture** – There should be a clear paradigm for what is in the core product, what is regional customisation, what is national customisation and what is specific for the bank, and what can be configured versus requiring product customisation. Related to this, there should be a clear approach for implementing core product upgrades and a track record of existing users of the product updating their implementations to the latest version.

2. Find The Right Partners And Get Them All Aligned

Core banking suppliers should have a range of credible partners that can implement their platforms, which reduces the risk of being locked into a single provider. Invest time and effort in selecting the implementation partner – or partners – that will work with you, bearing in mind that it is not possible or even desirable to offload all the risk onto them. Consider carefully the use of a single fixed price contract for the implementation – in our experience these can give banks a false sense that they have hugely reduced their risks and generate the wrong sort of incentives for suppliers. Once you have selected a partner, aligning all parties around approach and methodology is important – and this process should involve the core banking platform vendor as they will have their own processes particularly around core product customisation.

3. Define Clear Business Requirements

Clearly identify the business requirements that should be addressed by the new core banking platform, and do this as part of a thorough process of reviewing the core banking platform that has been selected in order to gain a clear understanding of the target platform. Business requirements should be the main framework to manage the scope of the programme and be the common thread throughout all aspects of the programme delivery. In order to capture requirements and to start evaluating the business change to be undertaken to adopt the new platform, a process-led approach should be used, taking end to end processes that cover not only the core banking platform but also satellite systems and manual operations. This was an approach we followed at a global bank that was rolling out corporate banking into dozens of countries, giving it a standard process blueprint that it could then tailor to each country as required.

4. Manage Scope, With A Focus On Adopt Not Adapt

Making sure scope is properly managed is one of the key success factors in ensuring delivery on the expected timelines. The entire organisation must be aligned on the principles of scope management, focusing on opportunities to optimise scope rather than inflating it. The key principle for this is to adapt the new banking platform, not to try to adapt it to legacy processes and functionality.

5. Design The End-To-End Solution With The Aim Of Minimising Complexity

One of the factors contributing to implementation challenges is the complexity of integrating a new banking platform into the existing technology landscape at a bank. A common approach to reducing complexity and the overall effort is to undertake a big bang migration or at least a series of big bangs by customer segment, which can avoid the need to operate dual interfaces with complex routing of data between old and new systems. We also recommend optimising the footprint of the new platform to minimise the amount of integration – a bigger footprint can be easier to implement than a smaller footprint with more interfaces. Finally, it’s also important to define the end-to-end solution which will cover many more systems than just the core banking platform – and using the end-to-end process approach described above can help with this.

Sources

36 For a general discussion of good practice in major programme delivery, see Start smart, finish strong: Engineer your major programs for success, Deloitte, December 2011, available at www.deloitte.com/view/en_CA/ca/services/consulting/ac1d1498a69c4310VgnVCM3000001c5600b00aCRD.htm
6. Define Quick Wins To Sustain Internal Buy-In
Define a roadmap with early deliveries to ensure the program has achievable short-term milestones. A transformation journey is a hard endeavour and needs these key intermediate milestones to ensure pressure points are present, motivation is continuous, and benefits are recognised.

7. Go Step By Step
Avoid jumping into a new phase without having the sign off of the current milestones. Starting new phases with previous deliverables under discussion is a real temptation and in most of the cases rework is the reward.

8. Strong Governance With Executive Sponsorship
Executive support and sponsorship must be present every single day. This is not a side-project. It must absolutely be at the top of the executive’s agenda. Lack of management commitment is one of the main causes for programme failure and is often characterised by lack of scope control – the principle of adopt not adapt covered above gets compromised. A core banking programme needs business and management support on a full-time basis and should not be labelled as an IT programme.

Below is an illustration of a typical governance structure:
9. Deliver Smartly And Put In Place Effective Communication

In the words of Paul Marriott Clarke, MD Retail Banking at Metro Bank, “The big lessons for me are to work to challenging but achievable deadlines, encourage institutional honesty about where we are, and ensure effective communication”\(^3\). Define an effective communication strategy as well as a clear vision of the main benefits of the programme. Share with all people how they will benefit from this big change.

The communication plan should:

- Outline key communication priorities and needs of key leadership groups
- Ensure an integrated overall approach to programme governance, ensuring that time is used as efficiently as possible to support a fast-tracking environment
- Define a detailed schedule for communication both within and between groups, including key inputs, outputs, and frequency for meetings
- Set guidelines and standards for communication development and delivery

10. Invest In A Good Business Case And Use It

The business case should be able to demonstrate cost savings (such as lower operational costs) and increased revenue (such as a new offer range and a faster time-to-market). Metrics are fundamental to effectively measure the real value of the programme thus giving comfort to the bank’s shareholders and sponsors, and the business case can be a key tool to support decision making during the programme.

<table>
<thead>
<tr>
<th>Benefit</th>
<th>Description</th>
<th>Indicators</th>
</tr>
</thead>
<tbody>
<tr>
<td>Growth</td>
<td>Assets under management; top-line revenue; number of customers</td>
<td>New Revenues; Deposit Base</td>
</tr>
<tr>
<td>Customer / Brand</td>
<td>Customer experience; quality of service; external brand; customer insights and analytics</td>
<td>Net Promoter Score; Share Of Wallet</td>
</tr>
<tr>
<td>Business Agility</td>
<td>Business changes and innovation; M&amp;A activities, major project delivery; future flexibility and extensibility</td>
<td>Net Promoter Score; Share Of Wallet</td>
</tr>
<tr>
<td>Cost / Efficiency</td>
<td>Efficiency of on-going operations; run-time costs; application portfolio complexity; STP</td>
<td>Operational Costs; Efficiency Ratio (NIX); HW/App Reduction</td>
</tr>
<tr>
<td>Capacity / Effectiveness</td>
<td>Capacity and effectiveness of the bank to deliver technology-enabled solutions</td>
<td>#Changes Supported; #Major Incidents; #FTEs Required</td>
</tr>
<tr>
<td>Regulatory Risk</td>
<td>Ability to adhere to changes in laws or regulations (e.g. SoX, AML, SEPA, etc)</td>
<td>Regulatory Compliance Costs</td>
</tr>
<tr>
<td>Credit and Operational Risk</td>
<td>Ability to manage credit (e.g. loan losses, receivables) and operational risks (e.g. fraud etc.)</td>
<td>Loan Loss Provisions; Traceability; #Security Breaches</td>
</tr>
</tbody>
</table>

It’s interesting to compare core banking replacement programmes with two other scenarios. The first is the post-merger or post-acquisition integration of two banks, where there is typically an extensive programme to rationalise systems including core banking systems; typically the merged bank in this situation will choose one of its existing core banking platforms as the strategic platform and migrate customers and accounts onto this, with the leadership of the bank mandating acceptance of the functional compromises that this may impose. The second is the Greenfield scenario, where the IT estate has to be built and there is no data migration, and there is a focus on getting to go live typically with a small set of product variants, often with a small, close-knit leadership team running the implementation. Both of these scenarios have the common features of leadership focus and drive to implement quickly, cutting through complexity and forcing rationalisation of both products and technology. We think an existing bank planning on replacing its core system(s) could learn lessons from these scenarios, and even adopt a similar approach, setting up a Greenfield operation and IT estate and then migrating its existing customers onto it.

Sources
37 Metro Bank: Launching the UK’s first new high street bank for 100 years Deloitte case study dated 2011 available at www.deloitte.com/view/en_GB/uk/services/consulting/strategy/f0b6968e84aed210VgnVCM2000001b56f00aRCRD.htm
In October 2007 the banking industry was in meltdown. It hardly seemed an auspicious time to launch a new bank. However, the founders of Metro Bank thought differently.

In 2008, Vernon Hill and Anthony Thomson asked Deloitte to help them write a business case for a new breed of bank. It would open seven days a week, allow you to set up an account instantly, and your dog would be welcome too.

Metro Bank then selected the Temenos T24 banking platform and subsequently asked Deloitte to support its UK banking licence application and run over a period of 8 weeks the selection of an IT hosting partner. Following this achievement, Metro Bank asked Deloitte to supply an Acting CIO to manage the delivery of all IT infrastructure and services up until launch.

Despite the economic downturn, Metro Bank launched successfully on 29 July 2010. Using the Temenos T24 banking platform means that Metro Bank’s IT is fundamentally less complex than those of other UK banks. This has enabled Metro Bank to achieve a number of market firsts - including allowing customers to open current and credit card accounts, and receive their debit and credit cards, and a cheque book on the spot.

The press welcomed “a genuine alternative to high street banks” that could “raise the bar for service in the industry”. Meanwhile Metro Bank acknowledges Deloitte’s IT expertise as core to its success in launching.

Case Study

Metro Bank

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38 Both Temenos and Deloitte have written detailed case studies about Metro Bank, which can be downloaded at: www.temenos.com/profit and http://www.deloitte.com/assets/Dcom-UnitedKingdom/Local%20Assets/Documents/Services/Consulting/UK_C_Metro-bank.pdf, respectively
Summary

Between 1980 and 2007, the banking industry enjoyed somewhat of a golden age, during which strong economic fundamentals, coupled with deregulation and high leverage, sustained higher returns on equity than at any other time in the industry’s history.

However, the profitability outlook for banks has deteriorated. In the post-crisis context, governments are seeking to make the industry safer by introducing tougher regulations, for example, enforcing higher capital adequacy levels. Funding costs have increased in line with a relative shrinking in the wholesale market. Markets have become more highly contested with the arrival of new competition, such as retailers offering retail banking services, and banking customers are taking advantage of more competition and ever greater pricing transparency levels to oblige banks to improve service at the same time as lowering prices. All in all, banks’ RoE levels have come under pressure and, compared to pre-crisis, a profitability gap has emerged, which we estimate to be around USD310bn.

In this report, we have set out the ways in which core banking replacement could help banks to raise RoE. We have argued, giving concrete examples, that modern, third-party core banking systems give four levers to improve RoE, namely, the ability:

• to cut costs sustainably
• to raise asset yield with existing businesses
• to move quickly and easing into more profitable banking segments
• to extract economies of scale from organic and inorganic growth

Banks running modern core banking systems have taken advantage of these characteristics to generate superior profitability. In this report, we have shown, using publicly-sourced information, that banks running modern, third-party core banking system enjoy higher profitability than banks running legacy systems – a 37% higher return on capital, for instance – while the relative profitability of Temenos customers is higher still.

Applying this analysis to the profitability gap has led us to conclude that universal adoption of modern, third-party core banking systems could enable the banking industry to reduce its USD310bn profitability gap by between 25% and 60%; that is, in the scenario of all banks using software from Temenos, we have argued that the banking industry’s post-tax profits could rise by c. USD180bn.

Although these findings are compelling, few banks in relative terms have acted to modernise systems to date since there has been minimal market sanction for not doing so, but we believe banks can no longer wait. In the developed world, given structurally higher costs and the compounding effect of faster growth in costs than revenues, we believe that the industry could be rendered unprofitable within 10 years if it fails to act. While in emerging markets, more rigorous competition coupled with growing customer sophistication will oblige banks to raise service standards at the same time as lowering costs to serve, meaning that they will need to tackle technology inefficiency to stay competitive.

In the final section of this report, we have looked at why core banking replacement projects have tended to fail in the past and have offered a comprehensive set of best practices to minimise risks and maximise returns from these modernisation projects. We have given some concrete examples of where banks have adhered to these best practices to realise highly successful outcomes from their core banking replacement projects.
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About Temenos

Founded in 1993 and listed on the Swiss Stock Exchange (SIX: TEMN), Temenos Group AG is the market leading provider of banking software systems to retail, corporate, universal, private, Islamic and microfinance & community banks. Headquartered in Geneva with 64 offices worldwide, Temenos has over 1500 customer deployments in more than 125 countries across the world.

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According to IBS Intelligence, which maintains an annual league table, TEMENOS T24 has been the first or second best selling core banking solution for the last 14 years and in 2010 was the best selling solution for the fourth year in a row. Forrester ranks Temenos as its sole global power seller (Forrester Global Banking Platform Deals Report 2011) and Temenos has been the winner every year since its launch of the Best Core Banking Product in Banking Technology magazine’s Readers’ Choice Awards. In 2011, Temenos also received two Financial Sector Technology magazine awards - Best Use of IT in Retail Banking for the Metro Bank project and Technology Provider of the Year.