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# 2018 Banking Outlook

Accelerating the transformation

Deloitte Center *for*
Financial Services

# Foreword

**Dear readers**

We are delighted to present to you the Deloitte 2018 Banking Outlook. This looks at significant global macro themes which resonate for the Irish market.

Ireland has one of the highest volume of mobile phone usage per capita in the World, this presents a challenge for the Irish financial services sector to develop products and services that meet the Irish consumers' expectation for a frictionless digital experience.

The banking market's construct has altered from one of bricks and mortar, traditionally held in high regard as a core trusted institution in the Irish psyche to a Digital service-focused market driven by a new generation who are very comfortable switching to European competitors or slicker more customer-savvy Fintechs.

Innovation is a must to secure a continued place in this market. Competition is coming in many forms from traditional financial institutions to Big Tech players, to small, medium, and large Fintechs.

Innovation won't just apply to the latest technologies. It will include reimaging how our day-to-day banking and financial needs are serviced.

Recently Deloitte undertook a Digital Maturity Study of 8,000 customers and 238 Banks across 38 EMEA Markets. The research illustrates how highly diversified the banking industry is from the point of view of Digital Maturity. The 'Digital Champions' identified across the EMEA have proven themselves by offering a wide range of functionalities that are highly relevant to customers, while also managing to deliver compelling customer experiences.

Banks and associated markets were categorised across four key maturity states 1) Digital Champions 2)Digital Smart Followers 3) Digital Adopters and 4) Digital Latecomers.

We found that although Irish customers are highly digitally literate and demanding, Ireland is lagging behind when benchmarked across the EMEA as a 'Digital Latecomer'. Specific challenges were highlighted across day to day banking experiences and customer engagement.

Our study also highlights the extent to which PSD2 and Fintech will apply significant market pressure by introducing new "Digital Champions" across the competitive landscape. This presents both challenges and opportunities for current incumbents in the near term, and much to consider as regards customer engagement vision and enabling digital transformation plan.

We will be launching this study over the next few weeks, including a deep dive into the areas where the Irish banks have performed relatively well and some of the specific areas identified for improvement.

With change being the only true constant we wish you an insightful read of the concepts and insights in this outlook

Sincerely

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# Playing the long game

**For banks globally, 2018 could be a pivotal year in accelerating the transformation into more strategically focused, technologically modern, and operationally agile institutions, so that they may remain dominant in a rapidly evolving ecosystem.**

This metamorphosis is far from easy as most banks grapple with multiple challenges: complex and diverging regulations, legacy systems, disruptive models and technologies, new competitors, and, last but not least, an often restive customer base with ever-higher expectations.

In this outlook we explore the challenges most banks face in balancing the need to restructure their foundations for the long-term with finding near-term growth.

We do so by identifying six macro themes that should be critical for long-term growth: 1) Customer centricity, 2) Regulatory recalibration, 3) Technology management, 4) Mitigating cyber risk, 5) Fintechs and big techs, and 6) Reimagining the workforce. Then we drill down into five business segments to address how these long game themes may begin to play out in the next 12 to 18 months (see figure 1).

**Figure 1: Six macro themes and five banking businesses**


Source: Deloitte Center for Financial Services

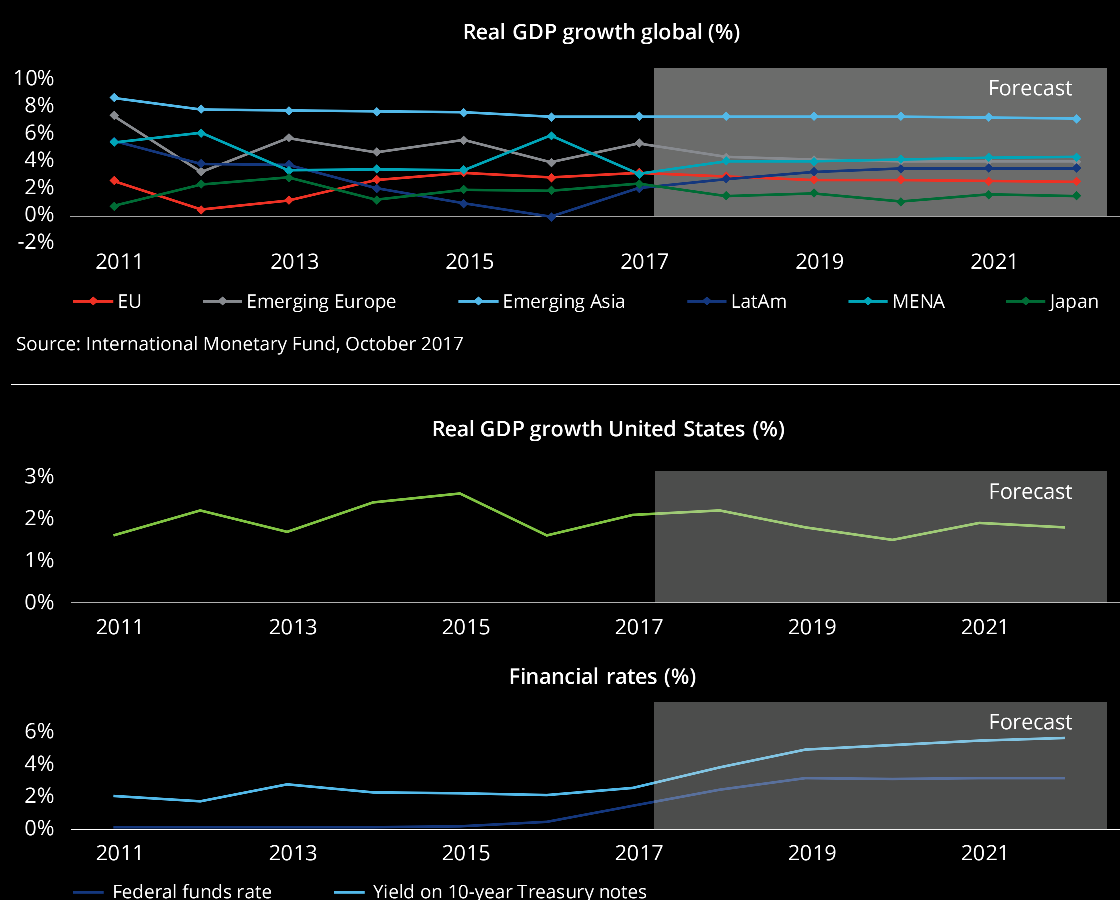
But first, some background on the global economy: Real GDP growth should stay healthy across most major markets (see figure 2), giving most lines of business some room for topline expansion. Also, the continued tightening of labor markets in the United States and more recently in the European Union,[1] should fuel income gains and credit expansion for retail banks in the near term. This favorable situation could also lead to monetary tightening, as the European Central Bank (ECB) may gradually reduce its quantitative easing program, and raise interest rates, as the Fed has done.[2]

Meanwhile, real fixed-business investments and corporate profits may also rise, albeit at low rates. And corporate tax reform, as currently proposed in the United States, could mean repatriation of US corporate profits leading to a surge in business investments. On the flip side though, large unfunded tax cuts could fuel concerns in bond markets about the long-run sustainability of US budget deficits.

Finally, backlash against globalization and foreign trade[3] does not seem to have manifested in damage to cross-border flows.

In the end, banks have to contend not only with **running the bank, but also transforming the bank** to grow in a sustainable manner. Banks will likely have no choice but to balance these goals against the exigencies of the day. And those that are able to achieve this balance could be amply rewarded.

**Figure 2: Real GDP growth and interest rates**




Source: Deloitte United States Economic Forecast 3Q 2017

## Customer centricity

**Long-term sustainable growth in the banking industry seems only possible with a radical departure from a sales- and product-obsessed mindset to one of genuine customer centricity, and further rationalization of strategies to target the right markets, customer segments, and solutions.**

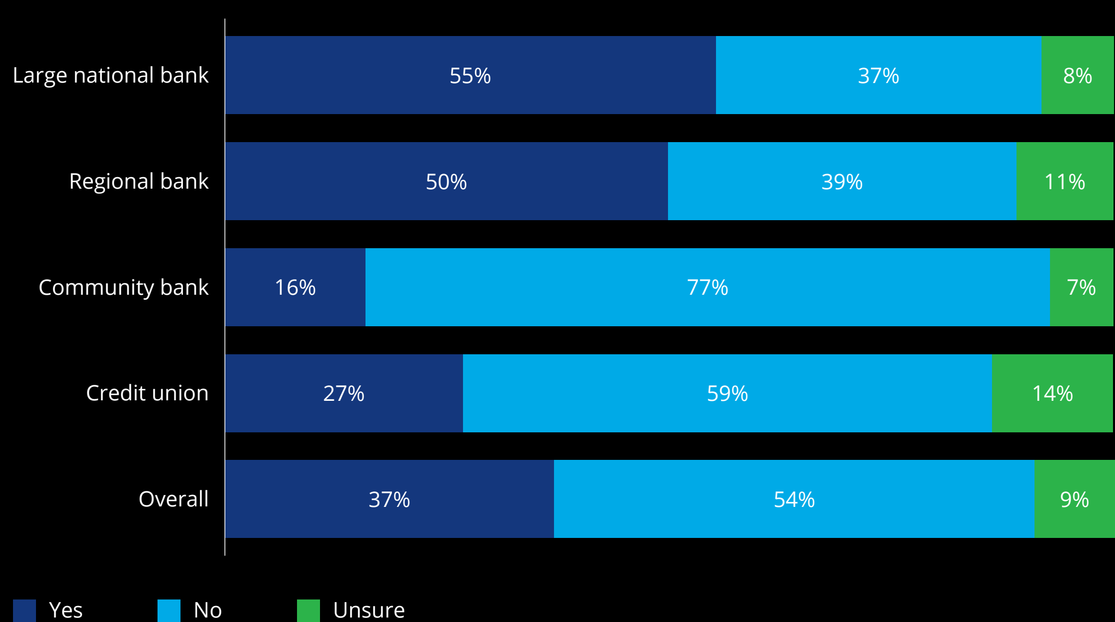
Although banking has undoubtedly improved in many ways in the last couple of decades, most organizations have not gone through the customer-centric transformation that other industries have undergone. With widespread digital disruption, banks may even risk losing control over customer experience.

Of course many banks, global and local, large and small, have changed their market and customer strategies since the financial crisis. Many of these decisions may have been forced upon them by regulatory expectations, and perhaps are not necessarily grounded in a refined understanding of markets and customers. As figure 3 shows, banks' focus on customer experience, at least in the United States, does not appear as widespread as one might expect.

Fortunately, most banks seem to have realized that a growing fintech ecosystem, once perceived as a threat, can actually be a boon for helping them serve their customers, both through emulation and collaboration.[4] Fintechs, with their laser-sharp customer focus, have shown that it is possible to meet, and arguably even exceed, customer expectations.

But technology is typically only part of the solution. The core objective for most banks is to achieve **organizational agility**, and to do so they should consider embracing innovation, managing talent differently, and pursuing key partnerships within a broader ecosystem to manufacture and deliver solutions for customers.

**Figure 3: US banks, by type, with defined customer experience programs**




Source: DBR Research© February 2017 The Financial Brand

## Regulatory recalibration

**2018 presents an opportunity to modernize regulatory compliance and bring together disparate silos created for individual compliance goals.**

After a decade of intense scrutiny by regulators globally, banks seem to be sensing some stabilization. At least in the United States, new rulemaking appears to have abated. There are also signs of divergence among national regulators, who, after a period of unprecedented coordination following the financial crisis, appear to be pursuing paths suited to regional and national priorities. For example, many global firms are dealing with varying local market needs and regulatory mandates, and more recently, with differing views on key prudential regulations, such as the still-pending aspects of the Basel III regime.[5]

But expectations of a broad regulatory pullback could be misplaced. Some US regulations are being reviewed and may be amended, such as the Volcker Rule,[6] regulations around governance expectations of bank boards, and the size threshold for systemically important institutions. However, higher capital and liquidity requirements, stress testing, and recovery and resolution planning will likely remain intact. Compliance expectations, especially around fair treatment of customers and executive accountability, are expected to stay elevated. Regulators are also expected to maintain vigilant enforcement programs and to demand more data from banks to test the operational integrity of complex institutions—especially when under stress.

In Europe, the Markets in Financial Instruments Directive II regime and proposed EU rules to establish intermediate holding companies—similar to those required under US regulation—should continue to be significant priorities for global banks. Additionally, the second Payments Service Directive (PSD2) regime could have spillover effects across geographies.[7] Data protection rules, especially the General Data Protection Regulation, should further add to the compliance burdens.

So how can banks operationally achieve this modernization? Consider integrating regulatory compliance goals—from the standpoint of ownership and accountability—with strategic initiatives such as growth, operational simplification, risk management, and cost efficiency. Simply put, **regulatory compliance should be aligned with business strategy.** Not doing so could put banks at risk of unmet regulatory expectations and subpar performance.

Regulatory compliance should also figure prominently into the "portfolio of change" that banks need to make and manage—at both the individual business and enterprise level. This portfolio of change requires leaders to consistently apply a standard of due care in managing businesses. Heightened focus on executive accountability is also being codified in regulatory expectations such as the Senior Managers Regime in the UK.[8]

### In the face of Brexit uncertainty, banks prepare for maximum change

The uncertainty over Brexit negotiations between the United Kingdom and the European Union is forcing banks to prepare maximum change contingencies that have the potential to be operationally disruptive, legally challenging, and financially demanding.

Institutions are taking on the tough task of setting up new operational entities in Europe following the potential loss of "passporting" arrangements for UK-regulated entities. After which they will have to determine the size and scope of these new entities, relocate or hire new personnel, commit fresh capital to meet local regulatory demands, and revamp recovery and resolution plans to address these new challenges to their operational integrity.

Some banks have already taken action in this regard. Others may yet act in defense of their competitive position and to protect their ability to operate smoothly. These decisions are likely to create long-term impacts not only for banks, but also for London as a global financial center. Eventually these shifts could contribute to fragmentation of banking and capital markets businesses on the continent, with unforeseen implications.

## Technology management

**To help banks become more agile, bank CIOs should manage their portfolio of technology assets to emphasize activities that truly differentiate the bank. Externalization efforts should be focused on generic functions with an emphasis on cost efficiencies.**

Technology resources at most banks are becoming difficult to manage, with a hodgepodge of systems, platforms, software, and tools—much of it legacy infrastructure that demands significant resources and capital to ensure that operations run smoothly. As such, modernizing core operating infrastructure is an obvious priority. Modernization ranked as the most important IT trend for nearly a quarter of global banking respondents in the 2016 Ovum ICT Enterprise Insights survey.[9]

To "change the bank," CIOs have to simultaneously ensure that new solutions sourced from multiple external vendors are integrated to maximize value creation, while minimizing internal disruption. To make this happen, tech budgets at banks will likely continue to expand; Gartner's research shows the global banking industry will spend $519 billion on IT in 2018, up 4.1 percent year over year (YoY) from $499 billion in 2017.[10]

Money itself is not typically enough. In their drive to simplify and modernize, and to build technology agility, banks should ask themselves three important questions:

1. How can they best manage the portfolio of technology assets to deliver the most impact for businesses?
2. What is the right level and type of technology externalization (i.e., the use of third-parties to design, develop, and manage technology solutions)?
3. How do they direct development resources toward only the activities that truly create competitive differentiation?

Fortunately, the proliferation of technology vendors and platforms, and the maturation of cloud solutions, has made technology externalization more viable. Of course this is not a new concept for banks, but there is often a need for a significant ramp-up in externalization to ensure that the institution remains competitive in the marketplace. Banks' technology groups can play a key role in orchestrating this new model of externalization, and ensure that these efforts have the greatest business impact.

Admittedly, externalization is not the answer for every core activity—there will still be some activities, such as compliance and risk management, that will usually be maintained internally, and for which internal technology support would remain critical.

Managed services for mission-critical activities that require specialized technical talent, but offer limited competitive differentiation to the firm,[11] are one example of externalization. Additionally, external service providers could automate compliance processes to eliminate hours of manual labor, but with bank employees handling the final layer of analysis and reporting to maintain accountability to regulators.

An externalization strategy typically also means more discipline in selecting technology vendors, with greater emphasis on high-quality software asset and business expertise (in mortgage servicing versus demand-deposit-account processing, for instance). Multi-business institutions may prefer a hub-and-spoke model—with a wide variety of domain-specific third-party relationships—and reconfigured vendor contracting, risk management, and oversight practices, accordingly.

Externalization can also play a pivotal role in application modernization—in the form of rationalization, replatforming, refactoring, or rewriting code, and enabling platforms to migrate to the cloud.

In 2018, **we expect a "modest step to a big leap" in the way technology units within banks begin to transform themselves and redefine both their role and value within the organization.** Breaking institutional barriers to such change may prove to be a big challenge.

## Mitigating cyber risk

**The potential for cyber risk has been increasing with greater interconnectedness in the banking ecosystem, rapid adoption of new technologies, and continued reliance on legacy infrastructure designed for a different age.**

These challenges are generally well-recognized—cyber risk is a top concern for financial services risk managers.[12] Staying ahead of changing business needs and addressing threats from increasingly more sophisticated actors are top challenges for executives.[13]

This level of maturity is also reflected in the way cyber risk is currently managed at many banks. In particular, funding for cybersecurity continues to increase and there is greater cooperation among banks, counterparties, and regulators, including sharing of information and best practices. Also, many banks have been able to recruit specialized talent into their cybersecurity units.

Yet cyber risk is only getting more complex, and in ways that are not fully understood and predictable by many. Hence, there is more to be done to make sure that cyber risk is baked into the bank's operations *ex ante*, as opposed to *ex post*. That begins with building a robust culture of due care across the organization, and ensuring that cyber security is a key consideration in the design of business processes, strategy, and innovation.

Since the transformation underway in many banks is largely technology-driven, they should ensure cyber risk is explicitly considered and managed in every aspect of change—whether overhauling legacy systems or adopting new technologies. This focus on cyber risk as a critical element in almost every aspect of business will have numerous benefits. This includes the ability to improve speed to market and the ability to make firms more resilient and responsive to market needs, which is the very definition of agility. In short, cyber risk should be a core decision-making factor in everything banks do to transform and become agile.

For example, as automation kicks into high gear through robotic process automation (RPA) and cognitive technologies, developing cyber security protocol in the design and oversight of these systems will be key. Similarly, as banking inevitably intersects with the Internet of Things (e.g., smart watches, AI devices); cyber risk will have to become a dominant component in every decision. Open application programming interfaces (APIs) are another example of cyber vulnerability that will need particular attention.

As it relates to regulations, banks could be leaders by exceeding mandatory state and federal regulatory compliance directives and ensuring robust cyber risk management systems.

## Fintechs and big techs

**Fintechs continue to lead innovation in the banking industry by sharpening their focus on customer experience. Banks face a number of choices: replicate what fintechs are doing, respond with equally innovative solutions, become more symbiotic and less competitive, or pursue a mix of these strategies that fit their unique capabilities and market positions.**

Although fintechs have undeniably made their mark on the banking industry, many would agree that they have "failed to disrupt the competitive landscape."[14] It seems premature to view fintechs and other nonbank players through the disintermediation lens. Incumbents will likely maintain market leadership due to three factors that work in their favor: 1) regulatory barriers to entry; 2) the natural inertia of customers to switch; and 3) the capital to absorb, partner with, or replicate fintechs.

However, it should be acknowledged that many fintechs have created innovative solutions that "are setting new and higher bars for user experience."[15] But what these fintech and other nonbank tech players in the banking space appear to represent is perhaps a changing ecosystem.

As for technology behemoths' acquiring banking charters and posing a threat to incumbents, achieving regulatory compliance and inducing customers to switch can be daunting tasks. Instead, these firms will likely be more successful servicing and partnering with banks, especially in the area of data sourcing, data analytics, and cognitive technologies.[16]

Learning from fintechs and technology firms could also help banks rethink their competitive benchmarking. As fintechs and other nonbank players encroach on various business lines (e.g., lending, payments, trading, wealth management), it may behoove incumbents to compare with those they consider best-in-class in terms of the capabilities and solutions. This expansive view of competition can make them less vulnerable to future threats.

To this point, banks can develop a more nuanced approach to fintechs by disaggregating the impact of fintechs on various business functions, including operations, finance, and marketing.[17] Exploring open APIs can also be important, as open banking would speed the integration into the rapidly morphing fintech-based ecosystem. The all-important byproduct of all of these efforts would be that incumbents become more adept at developing solutions that customers (existing and prospective) want and need.

## Reimagining the workforce

**Banks should consider rethinking their workforce strategy given how work is evolving—with increasing automation[18] and greater diversity in the labor pool.**

There is little doubt that automation is rapidly transforming work, and advances in technologies such as quantum computing will likely only accelerate this change. A seemingly natural reaction to the inevitability of an increasingly automated world could be to speculate about the impact on jobs,[19] yet alleviating "automation anxiety" in banking is far from new.[20] For example, ATMs allowed banks to reorient tellers to sales and advisory roles from purely transactional activities.[21]

The future workforce is expected to also be more diverse than it is today. In addition to permanent employees and contractors, it will likely include freelancers who work with multiple banks, fintech hackathoners to generate novel solutions, and even robots that work alongside humans.[22]

While it is tempting to think that technical talent might be all that a bank really needs to succeed in a technology-driven world, it would be short-sighted to ignore the value of enduring human skills. Banks should continue to align the organization more deliberately with the values of employees as part of corporate social responsibility (CSR) and environmental, social, and governance (ESG) efforts.

How prepared are institutions for this transformation? So far, only 17 percent of global executives across all industries, let alone banking, responding to the Deloitte Human Capital Trends survey say they are ready to manage this diverse workforce of people.[23]

Bankers would need upskilling to work more effectively in a digital environment, according to the *MIT Sloan Management Review* and Deloitte Digital's global study (see figure 4).[24] One global example is Singapore's DBS Bank, investing SG$20 million to train its existing workforce in digital banking and emerging technologies, via an artificial intelligence (AI)-powered e-learning platform, curated curriculum, and module delivery.[25]

As part of this transformation, banks will likely need to reorient existing workforces to be collaborative and inclusive, while providing them with more integrated employee experiences—from recruitment to retirement—to mirror the richer customer experience that the workforce is enabling. **This workforce experience would have to be designed to accommodate a work-life balance, a purpose-driven career, and of course it should be digitally enabled.**

**Figure 4: The need and the will to reskill banking talent**


Sources: 2017 *MIT Sloan Management Review* and Deloitte Digital's global study; Deloitte Center for Financial Services analysis.

# Playing short to aim long

We've discussed six broad macro themes that banks should consider baking into both their strategies and thinking around long-term, sustainable growth. We consider this exercise the long game, and realize that the industry is in the initial stages. Accordingly, a way to address how the themes of this long game play out in the next 12-to-18 months might be to examine how they are being addressed along five broad business lines.

At a high level, retail and commercial banking should continue to grow at a healthy pace, but the challenge might be to adapt to a mobile-centric, customer-oriented world in which automation is increasing. Payments and capital markets businesses will likely witness the most change, with the former seeing unprecedented disruption, and the latter undergoing a shift in the basis of competitive differentiation. Wealth management, on the other hand, would need to evolve with the ongoing democratization of financial advice.

## Retail banking: Transitioning to a mobile centric and digitally anchored institution

**Banks should capitalize on the shift to a mobile-centric world by reorienting targeting strategies, product portfolios, and delivery models.**

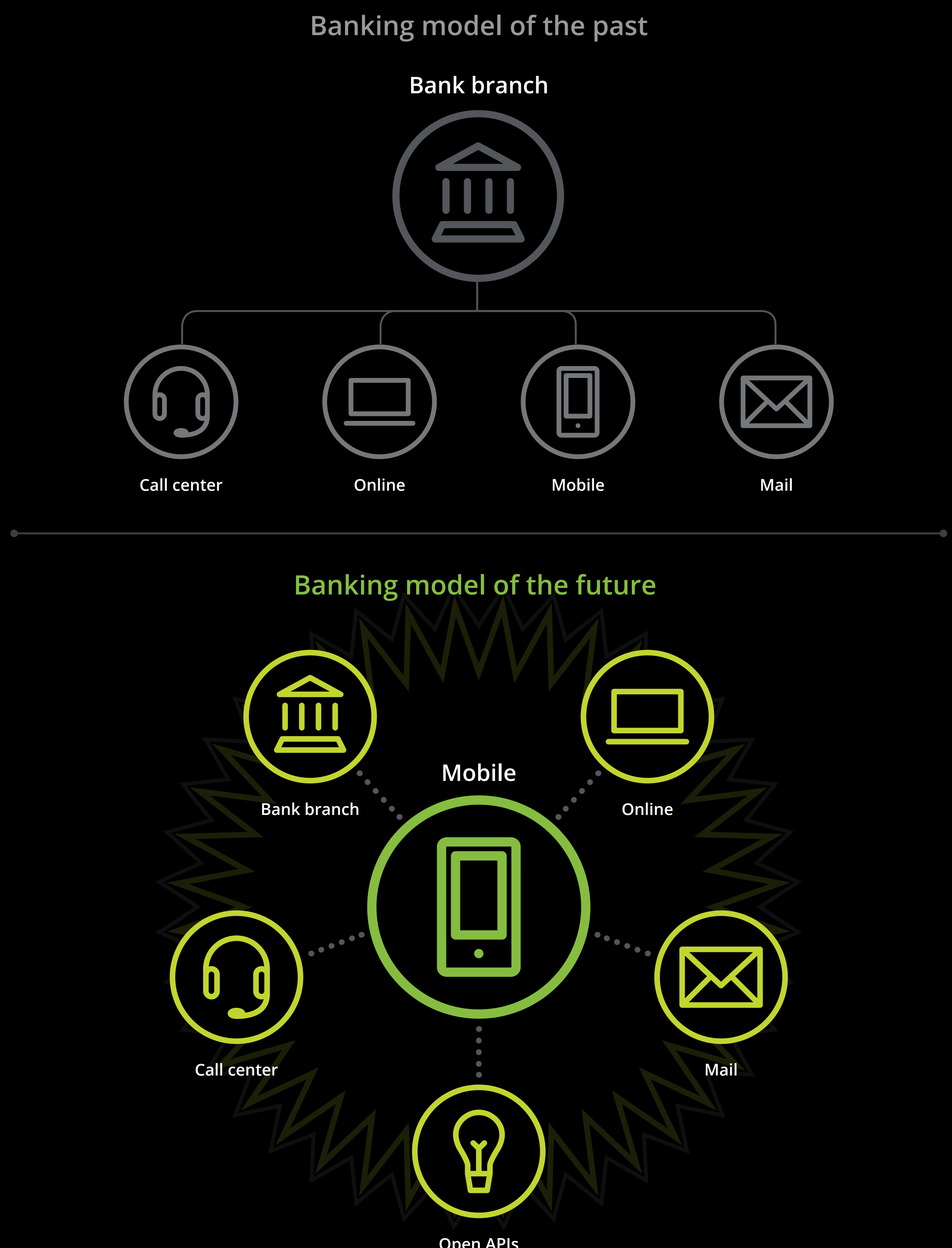
The United States is in the midst of the first interest rate increase cycle in over a decade. Signs of monetary tightening are also visible in the United Kingdom and Europe as economic growth strengthens. Banks that successfully target customers through sophisticated data analytics, make compelling product offers, and deliver strong digital experiences, could gain funding advantages and see slower increases in deposit costs. This targeting can be important, as post-crisis liquidity rules, particularly the liquidity coverage ratio, could fuel price wars for sticky retail deposits.

Deposit pricing pressures, as now seen in wealthier customers' accounts, could restrict the growth in net interest margins (NIMs),[26] a headwind that would prove challenging even if the yield curve in the United States steepens later in the rising interest-rate cycle. However, **strong retail deposit bases—linked to solid digital offerings and the ability to acquire new deposits—will likely drive better ability to sustain margins. The resulting flexibility in credit selection and pricing should support better asset quality and capital positions through the credit cycle.**

This context is important to frame the growing dominance of the mobile channel. It is fast replacing the branch as the focal point of the banking experience, achieving engagement even beyond that of online banking (see figure 5).[27] Mobile is also rising to the fore in critical processes in the customer lifecycle, and within key demographics—Millennials and mobile banking consumers are most likely to demand improvement in the account opening experience, according to a recent Deloitte study.[28]

Yet viewing mobile as just another channel is myopic. Mobile technology is not only a tool to enhance customer experience but it can also raise productivity in other channels (see figure 5). For instance, Umpqua Bank is piloting software that allows in-branch representatives to also serve as personal bankers on digital channels.[29]

**Figure 5: Mobile at the epicenter of customer experience**



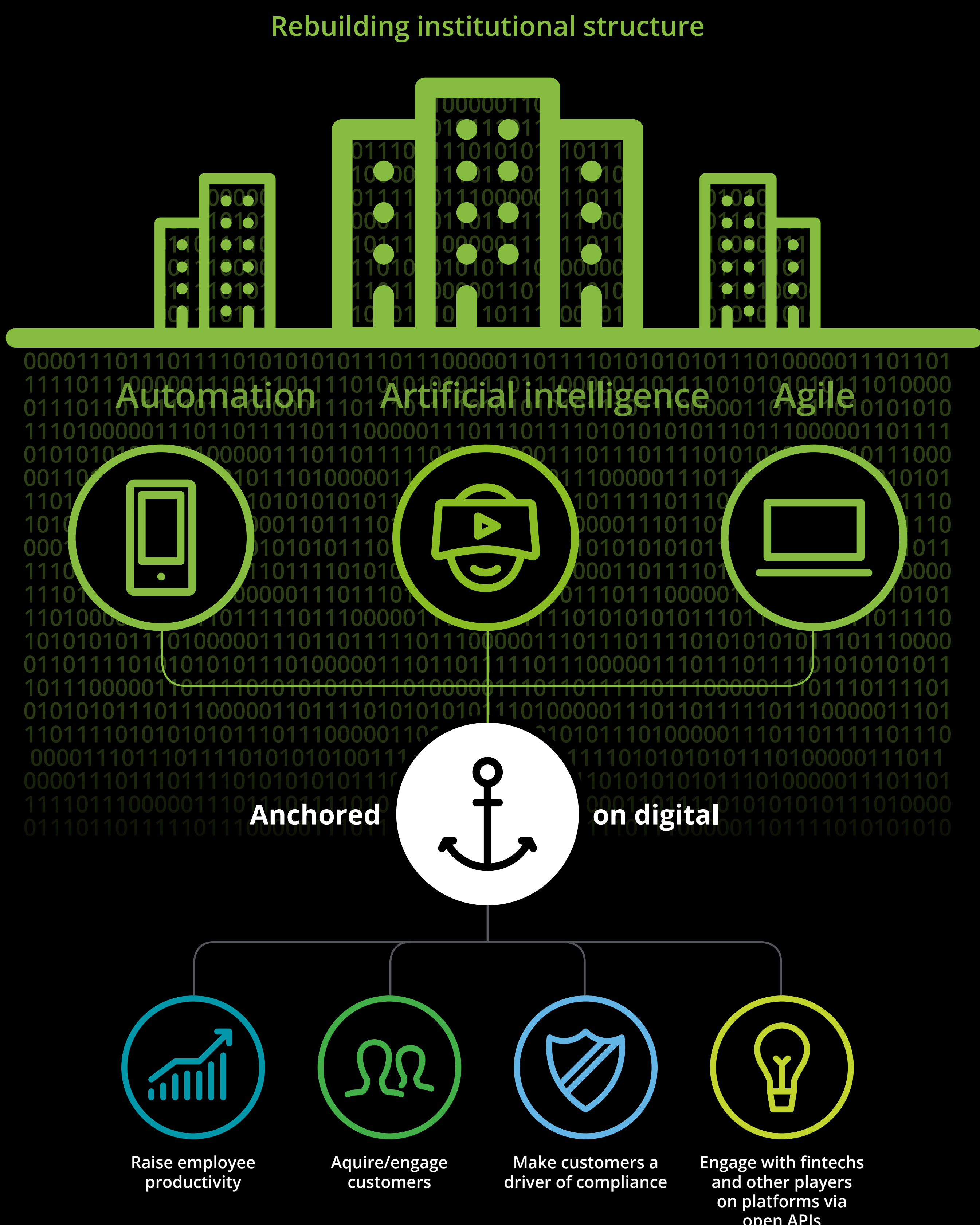

Source: Deloitte Center for Financial Services

A strong mobile offering can also make the customer a partner in compliance. Banks can use rewards or discounts to incent customers to provide consent or verify information on an app, for example, to speed up compliance and drive down costs. Verifying customer identity with facial recognition technology is another application that can enhance experience and reduce onboarding costs.[30]

The question, again, is how? US banks in particular appear to be lagging in adopting more mobile-centric and agile delivery models, but they **can make the transformative leap if they redouble their efforts to rebuild their institutions around digital** (see figure 6). Retail banking incumbents in Europe and Asia seem farther along this journey, and are creating radically different business models that may even cannibalize existing businesses. Regulation appears to be playing a key role in driving this change—PSD2 in Europe, and particularly the Open Banking Standard in the United Kingdom, have transformed rules on access and use of customer data, as well as lowered entry barriers.[31] These shifts are causing both banks and fintechs to also reevaluate how data are leveraged to reimagine customer experiences in an interconnected digital ecosystem.

The confluence of regulatory, technology, and balance-sheet strategies is important to this digital transformation. To adapt to these deep shifts, institutions are making what appear to be surprising strategic choices. Some examples are storied investment banks—such as Goldman Sachs[32]—now creating competitive, digitally driven retail banking franchises.

**Figure 6: Rebuilding institutional structure anchored on digital**




Source: Deloitte Center for Financial Services

## Corporate banking: Prioritizing customer experience, technology, and targeting markets

**In 2018, corporate banking divisions will likely target growth in select markets and make technology investments that enhance customer experience and simplify operations.**

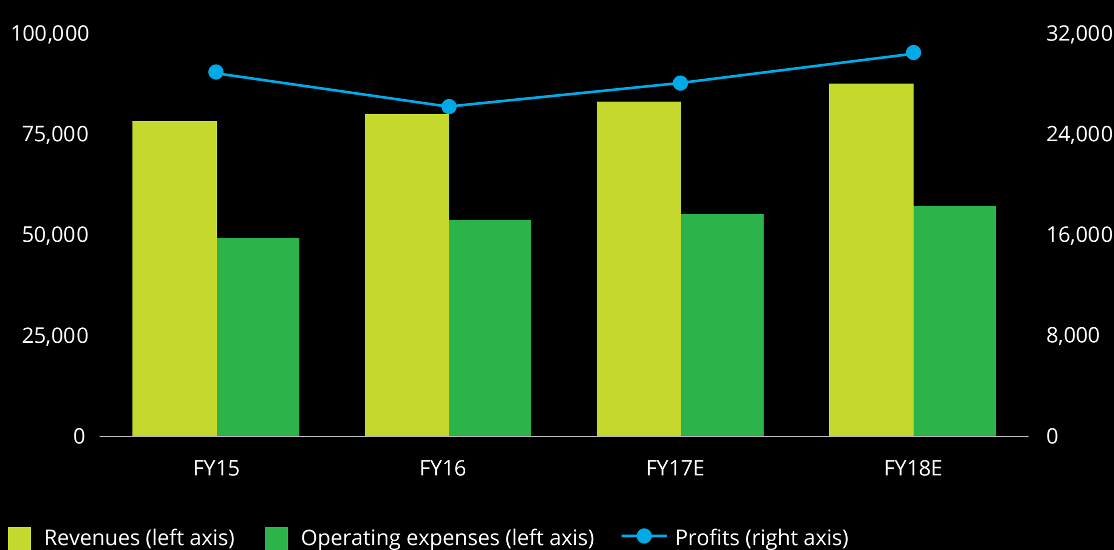
Global commercial and industrial (C&I) lending has been a mixed bag; Europe has witnessed caution as nonperforming loans (NPLs) hit new highs,[33] while in China historically high NPLs have been curtailed as authorities force banks to improve their balance sheets.[34] In the United States, despite tepid loan demand, rising rates have benefitted C&I lending.

However, C&I NIMs could be impacted by rising US corporate deposit rates. A slowdown in commercial real estate lending could further dampen margins, although regulatory proposals to simplify capital rules for real estate lending by small and regional banks[35] could boost loan growth.

In 2018, it would be wise to target prudent loan expansion in **the expanding middle market**, with revenue projected to increase 6 percent in the next 12 months.[36] In the United States, JPMorgan Chase is already seizing the opportunity, making middle market lending a centerpiece of its growth strategy.[37] Similarly, National Australia Bank has announced it will cut down the length of contracts and processes by one third for small business clients.[38]

Fee income also presents mixed growth prospects. Improved economic growth in the United States and Europe, the Middle East, and Africa (EMEA) should support commercial and transaction banking, and international payments revenues (see figure 7). Yet risk from the backlash against globalization could impact volumes in trade flows and international payments, for instance. Otherwise, following several solid years leading to M&A's deal volume remaining elevated and corporate debt issuance crossing the $1 trillion mark in 2017,[39] primary issuance and the M&A advisory businesses could stabilize in 2018 (see figure 8).

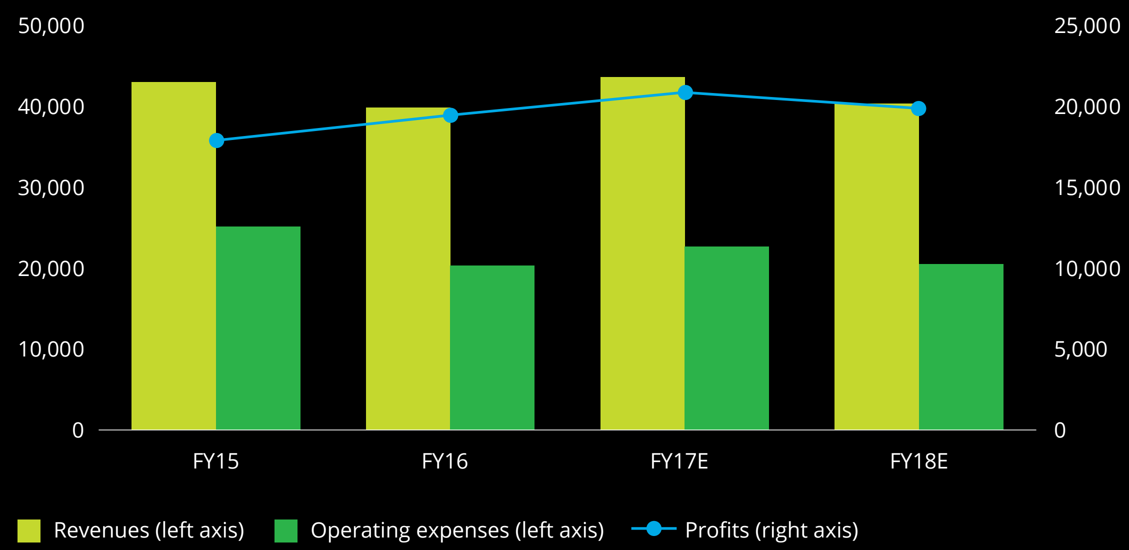
**Figure 7: Performance of the commercial and transaction banking and treasury services business ($M)**




Source: Tricumen forecasts

Note: Revenues reflect aggregate data of six major US and European banks.

**Figure 8: Performance of the M&A advisory and primary issuance business ($M)**




Source: Tricumen forecasts

Note: Revenue reflect aggregate data of 13 major US and European investment banks.

Meanwhile, many corporate customers, like their retail counterparts, are demanding seamless, tailored product and service choices with user-friendly interfaces. Hence, streamlining front-end operations could be an essential priority in 2018. Mobile and online banking emerged as the top IT priority for nearly half of the global corporate banking respondents in the 2016 Ovum ICT Enterprise survey.

With this backdrop, **corporate banking groups should ramp up their digitization efforts, especially in businesses that still heavily rely on manual, paper-based activities.**

But digitization without reexamining and improving business processes first can be counterproductive. Take RPA for example, which is likely to gather steam in 2018, where it is important to ensure that inefficiencies are addressed by rethinking how work is done rather than just throwing a bot at the problem. We also expect blockchain to gain traction, especially in trade finance and corporate payments, given their natural fit for blockchain's ability to eliminate duplication and errors inherent in a business hinging on multi party transactions. Already, seven large banks in Europe have partnered with IBM to construct a blockchain to conduct cross-border transactions for their small- and medium-size business clients.[40]

**Technology-enabled, front-end platforms should enable banks to cross-sell fee-based services to customers more efficiently.** Banks that pool data into lakes, for example, should enable the data to be tapped by sales personnel via digital interface at client meetings. These digital tools with cross-business data could allow junior bankers to work directly with customers without relying on the relationships of senior bankers, while also eliminating multiple roles in service delivery, all of which would reduce operating expenses.

## Capital markets: Leading technology adoption for competitive differentiation

**Automation and AI are changing many of the drivers of competitive differentiation in capital markets—in the front and back office—creating substantive knock-on effects on operations, talent, and business strategy.**

Fixed income commodities and currencies (FICC) trading has been emblematic of ups and downs in capital markets activity in recent years. Therefore it seems a good candidate to assess the transformation that banks can undertake to make the business more profitable and sustainable.

Many banks scaled back FICC desks due to post-crisis regulation, higher operating costs, and a shrinking revenue pool. However, front-office technology innovation, especially cognitive automation, can bring efficiencies and possibly new sources of growth. In the back office, the industry can confront a smaller and unpredictable revenue pool by mutualizing post-trade overhead across participants. Additionally, firms with the right talent to make this transformative leap will likely win market share. Once monetary policy tightens across global markets and volatility returns—there is no empirical reason for it to remain as low as it has been—we think that **banks that build the right capabilities and make the strategic choice to ride out near-term pressures (see figure 9) to stay with the FICC business could see big pay-offs.**

Examples of intelligent automation to create leaner front-offices and new products are becoming more common. For instance, Goldman Sachs has deployed bots to trade odd lots in corporate bonds so that human traders can focus on more lucrative work.[41] AI is also fueling innovation, as in UBS' "adaptive strategy" offering that customizes strategies for clients.[42] Sophisticated predictive analytics applied to transaction data are giving bankers the ability to anticipate client needs better.

**Figure 9: FICC performance ($M)**


Source: Tricumen forecasts of aggregate performance of 13 major US and European investment banks.

**Figure 10: Equities performance ($M)**


Tricumen forecasts of aggregate performance of 13 major US and European investment banks.

These technologies, along with the others such as blockchain, are also spurring change in the middle and back office. However, more likely needs to be done. True externalization—in which the infrastructure and the operations are run by a third party—may need to take hold as many capital markets businesses have become too costly to operate due to smaller revenue pools. Engaging specialized technology-enabled providers can be one way to more profitably manage these businesses.

Beyond technology, shifting talent needs reflect new drivers of business opportunity and shift risk. Hiring high-quality data modelers and cyber-risk experts has become a priority. Changing client needs and greater industry convergence also often necessitate that **banks augment pure industry specialists with domain-specialists** (e.g., an expert in platform business models who serves clients in multiple industries).

Banks' ability to stay ahead of these trends may determine the success and stability of their business models. The migration to electronic trading in high-margin products, like interest-rate swaps and greater price transparency with reporting requirements could result in increased margin pressure (see sidebar on page 17, "A MiFID II clean-up beckons.")

Finally, ongoing regulatory change makes for a demanding agenda. A material rewrite of the Volcker Rule could create vast changes in banks' strategies and market structure. Proposed rules in the European Union, such as the creation of intermediate holding companies for European entities that would be subject to EU prudential regulation, may result in meaningful operational and legal shifts. Additionally, Brexit continues to pose major challenges for many global banks (see sidebar on page 4, "In the face of Brexit uncertainty, banks prepare for maximum change").

### A MiFID II clean-up beckons

Many banks with global capital markets operations, particularly those in the United States, have been late in appreciating the sheer implications of the recording, reporting, and transparency requirements of MiFID II. Many firms are still scrambling to meet the fast-approaching January 3, 2018 compliance deadline, and much of the compliance achieved by that date could be imperfect and disorderly for many institutions.

Many data-reporting structures still need to be adequately refined. Client-facing compliance processes, such as recording calls or ensuring that client conversations do not drift into "informal" channels are going to require vast operational shifts. And while buy- and sell-side firms have begun to reshape their business models in response to the unbundling of research from other services, this recalibration could have vast implications for the investment industry.[43]

The scale and the relative unpreparedness by many for MiFID II suggests that a significant part of 2018 may be devoted to beefing up effective compliance and reevaluation of business models. Even those few that are ahead of the curve may find themselves working to truly embed these requirements into business processes, and respond to the competitive implications.

## Payments: Making the right strategic choices

**Incumbent payment providers have to make tough choices on whether to be one-stop providers of traditional *and* digital, frictionless solutions, or to leave some of the payments pie to the exclusive domain of fintechs and other emerging players.**

The competitive dynamics in the payment industry continue to intensify both among incumbents and alternative digital payment providers. A big challenge that incumbents face in this changing payment landscape is how to stay relevant to their customers while finding new income streams, especially as benefits from managing the "float" diminish with faster, digital payments.

In the United States, the Faster Payments Task Force's Call to Action and the launch of Zelle (a bank-owned peer-to-peer payments solution partnered with a number of major US banks) mark an evolutionary leap to catch up with other parts of the world, and are geared to benefit the US customer.[44,45]

In Europe, the upcoming PSD2 could push banks to open their APIs to third-party providers, enabling them to build new solutions on top of banks' data. It would also allow customers to authorize using bank account information for third-party applications, shifting ownership of this data to the customer. Adding to the regulatory developments, the Interchange Fee Regulation of the European Union, in 18 months of its implementation, has potentially axed €2 billion in credit card interchange revenue, while allowing an "Honor All Cards" rule (requiring merchants to accept cards of certain schemes) for the cards subject to interchange fees.[46]

But these developments have not slowed many incumbents' efforts to maximize the potential in traditional businesses. An example: card-issuing banks are flooding the market with reward-based products;[47] global card purchase volumes increased by 5.8 percent to $20.6 trillion in 2016, according to The Nilson Report.[48] Part of this growth is due to incumbents astutely adapting to "invisible" digital channels, such as online, mobile, and even AI (e.g., machines ordering and paying for their own fuel or supplies).

Retail and corporate customers today also have an increasing number of choices of non-payment-card digital payment solutions, offered through agile e-commerce players and fintechs. Investment firms have poured in $5.2 billion in payment fintechs alone in 2017, representing almost 40 percent of the total fintech investment in the banking industry.[49]

Increasingly, active collaboration with alternative digital players, in the form of partnerships or acquisitions, may be necessary, instead of colliding with them as threats. As part of this approach, incumbents should also prepare for the inevitability of open architecture, such as open APIs.

Banks have taken several approaches to the evolving ecosystem. Take peer-to-peer (P2P) payments, for example, where banks are creating their own solutions, partnering with other banks (e.g., Zelle), and participating in third-party platforms such as Venmo.

Mastercard's acquisition of Vocalink is another example of an incumbent expanding outside its core business.[50] Vantiv is going for scale, acquiring Worldpay to combine in-store transactions' complementary capabilities with online payments processing and expanding into the European market.[51]

Merchants are also getting fairly active in the payment space. They are now expanding payment options to drive customer engagement. Some are eliminating intermediaries altogether with a horizontal digital payment solution (e.g., Amazon Pay).

Of course, rapidly growing e-commerce is a catalyst for all of this payment innovation. But at the same time, brick-and-mortar is still relevant and an astute customer-experience-enhancing strategy should include omni-channel.

Banks could also focus on data monetization, as traditional revenue streams could dry up. They should also invest in big data and analytics that mesh with their own unique data to yield richer insights to, and about, their customers for further innovation and better business decisions.

The survivors in this rapidly evolving payment landscape will likely be those who are nimble and well-informed; or they may need to be fast followers who are able to leverage the intelligence they gather from the ecosystem to execute strategies that get quickly into the market.[52]

## Wealth management: Robo platforms expanding beyond investment advice

**Banks' wealth management units should keep the focus on the customer, as the migration to fee-based accounts accelerates and robo-advice becomes pivotal to both distribution and the brand.**

Access to high-quality advice is being democratized like never before—mass-market and mass-affluent customers are now able to avail themselves of services that were previously affordable only to high-net-worth clients. For instance, UBS wealth management's SmartWealth digital platform in the United Kingdom provides real-time advice to clients at a minimum investment level of £15,000.[53]

Higher standards of client service were already taking hold as a point of differentiation in the wealth management business, but the Department of Labor Fiduciary Rule seems to have further accelerated and codified this trend in the United States.[54] In the United Kingdom, the Financial Conduct Authority's annuity provider rules, encouraging more competitive shopping by consumers, similarly aimed to raise the bar on client care.[55] The changes these rules have set in motion in terms of the shift to fee-based models and rationalization of product portfolios are only likely to accelerate in 2018.[56]

**The homogenization of products and the secular shift toward passive investing could accelerate fee and margin pressure even as absolute revenues continue to grow.** As a result, commission-based accounts may get cheaper to attract assets and compete with fee-based accounts.

These pressures will likely require wealth management units at banks to balance several factors: pricing, product portfolio, and distribution.

Importantly, these shifts are occurring as wealth management becomes pivotal to banks' revenues, and becomes more tightly integrated with traditional consumer banking offerings and some key capital market products as well. As a consequence, wealth management services **could become the anchor for customer relationships in critical segments, especially among the mass affluent.**

The key to this transformation is likely not only to continue to strengthen core digital advice technologies. It will also rapidly expand investment in deeper and richer data sets, self-learning algorithms to drive critical customer-facing activities like chat bots, or more sophisticated and customized investment decision-making.

These digitization and automation initiatives can also contribute to greater advisor productivity,[57] and help solidify customer relationships. Next-gen, intelligent, and comprehensive **robo platforms can also become central to the distribution of even non-wealth products, such as mortgages, CDs, or credit cards.**

Even as firms experiment and expand digital capabilities, firms should also work to make robos a powerful, tangible, and differentiated representation of their brand. Customers might increasingly view these digital interactions as the focal point of reference for their varied financial needs.

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