European banks continue to be subject to a wide range of pressures, from the persistent low interest environment to evolving customer preferences, from the development of entirely new types of competitors to regulatory concerns. How can they adapt to these pressures and take advantage of new opportunities in this environment?
What are the key sources of pressure affecting the European banking sector today?

1. **Significant erosion of net interest margins as a result of the negative interest-rate environment**
   
   Interest margins of European banks have been meaningfully compressed since 2008 as a result of the low interest-rate environment. They have not seen meaningful recovery thus far.

2. **Increasing costs due to a more complex regulatory environment**
   
   Following the financial crisis of 2008, banks need to manage their balance sheets to fit a wider set of potentially conflicting regulatory ratios, pay closer attention to their risks, improve their governance structures, and comply with an increasingly vast body of consumer protection regulation. This has had a meaningful impact on all banks, but has particularly hit the smaller players that lack the economies of scale necessary to be able to absorb the impact of regulation.

3. **Evolving consumer preferences and the rise of competition**
   
   Customers are becoming increasingly well-informed and therefore more demanding in terms of pricing, convenience, and quality of service. Some of the barriers to switching providers are also disappearing with the shift to online channels and the advent of new regulation such as the Revised Payment Services Directive (PSD2) opening up access to customer data.

   Hand-in-hand with this trend, companies outside the banking sector (including telecoms, technology firms, and retailers) as well as independent entrepreneurs have started to launch alternative services in order to compete with banking providers. Competition has been increasing across all sectors, including a disintermediation of traditional credit activities (such as through crowd funding), automated advisory services (like robo-advisers for asset management) and a disruption in traditional payment activities with the advent of new technologies such as blockchain and the application of PSD2 that will force banks to open their infrastructure to innovative and lightly-regulated actors.
What are some of the strategic choices that banks need to make to tackle these pressures?

In order to frame their thought process, banks could consider the impact of each source of pressure on the various aspects of their target operating model. The model provided below is a generic example and could change depending on the bank’s core business.

**Market environment**
- Low

**Regulatory**
- High

**Customers & Composition**
- Medium

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**In our view, some strategic choices that could be considered are the following:**

**Impact on clients**
Banks will need to be increasingly focused on client service in order to catch up with the emerging competition and make up for prior underinvestment in customer experience. Nascent competitors are predominately targeting very specific user groups to win market share away from banks. Banks will therefore also need to define whether they will:

- Focus their efforts on certain client groups
- Maintain a broad service offering and service multiple types of clients
- Partner with other players either to reach new client bases or to outsource their client management experience

**Impact on channels**
Competition is increasingly technology-driven and focused on mobile and online channels. However, new competitors are currently unlikely to have sufficient scale and financial resources to quickly roll out a meaningful physical presence through branches. Banks will need to decide whether they will:

- Refocus their business on a digital-based operating model to reduce their cost base
- Maintain the competitive advantages they may have today with their large branch presence
- Partner with other players to improve their channel mix or outsource their channels for the use by other players
Impact on products
Clients are becoming increasingly less interested in selecting from a large range of bank-created products, and would either prefer their choice to be limited to a few offerings tailored to them or to be able to customize the products to their taste. Banks will therefore need to decide whether they want to:
• Focus and streamline their product offering
• Provide a wide range of products that will support customers through the various stages of their life (“one-stop shop”)
• Collaborate with other players, where the others could provide some products (where they have an advantage) on a “white label” basis or where the bank outsources some of its products

Impact on people, organization, processes, and technology:
Again, banks have several options here:
• Standalone cost rationalization—both traditional cost-cutting measures (e.g., rationalization of the branch network) and new non-traditional measures (e.g., investments in new technologies such as robotic process automation) can be foreseen
• Alliances—banks could consider merging some of their middle and back-office platforms in order to rationalize their cost base or consider expanding the reach of existing shared services entities to third parties as a commercial strategy
• Increased outsourcing—business process outsourcing companies could flourish in order to take advantage of the economies of scale in some of the middle and back-end processes and increase the variability of the cost base of certain banks

Impact on geographies
On the revenue side, banks could consider expanding their reach outside of Europe with its sluggish economy and move into other markets that are less affected by the current market environment. However, this needs to be balanced carefully with the need to adhere to a new set of regulatory and operating environments and the related risks.

On the cost side, moving some operations to lower cost locations remains an alternative.

What types of bank operating models could exist in the future?
Overall, some of the choices outlined above can be combined in several different operating models, joining the above elements. We discuss a few such models below:
• “The one-stop-shop adviser” model would target customers looking for convenience and a single provider that could service all of their needs
• “The balance sheet provider” model would target customers with large financing requirements
• “The innovator” model would target customers needing fresh, fast, and potentially lower-cost financial services
• “The infrastructure platform” model would act as a backbone service provider to other banks rather than serving the end client directly
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- The infrastructure platform
- "The one-stop-shop adviser"
- "The balance sheet provider"
- Independent BPOs
- Industry players (telecoms, tech, retailers)
- Marketplace lenders, crowd funding
- Small tech firms and entrepreneurs
- "The innovator"

Broad business model

Specialized business model
Certain players will aim to cover all of a client’s core banking needs across their lifecycle to improve their share of wallet, as certain customers will seek convenience. This could be done either through an existing operating entity or potentially through the creation of a “challenger bank” that expands its service offering over time.

### Customers and products
The customer will be served from their first student account to their retirement, with the products offered being constantly and proactively tailored to their stage in life (e.g., for retail customers, this would be credit cards upon first employment, mortgage upon marriage, and wealth management activities upon reaching a certain amount of accumulated net assets).

### Channels and geographies
The model to be followed will likely need to be omni-channel-based, with the customer being able to contact their adviser both remotely and physically, as specific life events (e.g., inheritance) have a particular emotional or confidentiality factor that requires face-to-face interaction. A physical presence will also improve the bond between the adviser and the customer. Several geographies can be targeted, but due to the need to expand the local advisory presence and parts of the physical network, the geographic expansion would tend to be more limited than in other models. In addition, a “travelling salesman” concept could be introduced instead of a traditional branch offering, with the branch staff being redeployed to other activities such as call centers and back office depending on the load distribution over the day.

### People, process, and technology
The bank will need to invest in data analytics in order to ensure that the customer’s key life events can be predicted with a certain degree of accuracy. Staff will need to be trained to be able to serve a wide range of products and potentially be able to fulfill a wider role within the bank (especially in the branch networks).

### Who could this model be suitable for?
This model is suitable for large universal banks, given their large existing physical networks and capabilities in multi-product offerings. Smaller banks with a more limited product offering could consider collaborating with other players, i.e., a conglomerate of smaller banks working together in competition with the larger banks.

### What are the risks?
The model’s success hinges on successful predictions relating to the customer life cycle. Additional regulation restricting product bundling and tying practices is another risk.

### Effectiveness of the model in addressing challenges
<table>
<thead>
<tr>
<th>Market environment</th>
<th>Regulatory</th>
<th>Customers and Competition</th>
</tr>
</thead>
<tbody>
<tr>
<td>HIGH</td>
<td>LOW-MEDIUM</td>
<td>HIGH</td>
</tr>
</tbody>
</table>

If executed well, the model should create additional value for customers and therefore improve volumes and margins. A multi-product offering is more challenging to manage from a regulatory perspective than a more streamlined business offering. Customer experience should improve, thus creating a competitive edge for the players that execute the model well.
The balance sheet provider

Certain banks will try to leverage their deposit gathering abilities and the size of their balance sheet in order to focus on credit intermediation activities and growing net interest income.

**Customers and products**
The product set will be limited to loans and deposits and could be more tailored to institutional clients, such as corporates, that require larger absolute amounts of financing. Balance sheet providers could also service other financial industry players, such as FinTechs, by providing them with the necessary financing to operate, thus detaching themselves from the “end customer.”

**Channels and geographies**
The model will have a higher balance toward online activities, with only limited physical presence for customer management due to narrow margins. The model should be relatively easy to expand on a cross-border basis, and would be particularly successful in geographies with a greater need for credit financing.

**People, process, and technology**
The bank will be narrowly specialized in a certain set of product types; therefore, the processes should be as lean and as simple as possible.

**Who could this model be suitable for?**
This model is for large banks with firepower to lend who do not have the capacity or the interest to further invest in customer-facing activities, as well as existing lenders with sophisticated credit risk management tools. This model is less suitable for smaller banks given the lack of economies of scale and increasing competition in this space from non-traditional lenders.

**What are the risks?**
The risks include the fluctuation of interest-rate levels (the model would be less profitable in the current environment) and margin squeeze by competitors such as asset management companies who may take customer liquidity away.

**Effectiveness of the model in addressing challenges**

<table>
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<tr>
<td>LOW-MEDIUM</td>
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<td>MEDIUM</td>
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</tbody>
</table>

In the current interest-rate environment, the model would have relatively low profitability; however, there is a meaningful upside when higher interest-rate levels return.

The model is relatively simple in terms of compliance; however regulatory capital developments will need to be monitored carefully.

Having a large balance sheet for lending purposes is a competitive advantage; however, the model can nevertheless be easily replicated by competitors and therefore the model is likely to remain low margin/high volume.
The innovator

Certain banking players will take the lead in new technologies.

**Customers and products**
This model would focus on targeting customer niches that look for innovative services (such as the Millennials) and specific products, thus requiring a high degree of specialization. “Innovation across the board” is unlikely to be achieved for the moment given the regulatory cost overhang and the need to monitor costs and budgets carefully.

**Channels and geographies**
The model will be predominantly digital in terms of channel offering, as customers will need to be able to switch into innovative services easily and at their convenience. The model is therefore likely to be easily extrapolated on a cross-border basis.

**People, process and technology**
The model could be achieved either through banks’ own investments (e.g., hiring of personnel for R&D purposes) or through partnering and incubating new innovative financial services players.

**Who could this model be suitable for?**
The model could appeal to banks with a light existing physical infrastructure (no large legacy IT systems and no existing branch network), e.g., smaller entities such as challenger banks and asset management-focused banks. This is also more suitable for mass-market services.

**What are the risks?**
The risks include not being able to find suitable personnel or partners for a successful innovative project and being subject to changing customer tastes. Lack of business diversification leads to a high risk/high potential return strategy. Technology failure is an additional consideration.

**Effectiveness of the model in addressing challenges**

- **Market environment**: HIGH
- **Regulatory**: MEDIUM-HIGH
- **Customers and Competition**: MEDIUM-HIGH

If executed well, the model would have great potential in overcoming the current market environment challenges.

Regulators are increasingly looking into innovative services and the risks these bring; this creates the possibility that additional compliance measures will be imposed in the future.

Assuming successful execution, the model can create a meaningful differentiating factor; however, the bank will need to stay on track with ongoing innovation.
The infrastructure platform

In this model, banks with existing large investments in systems, IT platforms, physical branch networks, and back-office processes could consider becoming service providers to other banks in order to make additional returns on their fixed cost base.

<table>
<thead>
<tr>
<th>Customers and products</th>
<th>The focus will be on servicing institutions rather than individuals, and breaking down various components of the bank’s operations to be sold externally.</th>
</tr>
</thead>
<tbody>
<tr>
<td>Channels and geographies</td>
<td>As the offering is not a mass-market offering, selling channels will mostly be “travelling salesman” style. The geographies served will be highly dependent on where the bank is present today and if its systems are adapted to an international environment.</td>
</tr>
<tr>
<td>People, process and technology</td>
<td>The operational processes will need to be carefully monitored and managed given the nature of the services to be provided.</td>
</tr>
<tr>
<td>Who could this model be suitable for?</td>
<td>This model could work for large banks with existing infrastructure platforms that are readily adaptable to other business models, e.g., provision of support with back-office processes, sharing of branch networks, etc.</td>
</tr>
<tr>
<td>What are the risks?</td>
<td>A large operational mishap or a reputational issue could create problems for the bank as a service provider and potentially even lead to its failure and exit from the market. There is a potential risk of margin squeeze by other banks or new entrants without legacy costs that are able to create a more flexible offering from scratch. New technologies could bring down the costs of setting up stand-alone platforms.</td>
</tr>
</tbody>
</table>
| Effectiveness of the model in addressing challenges | ![Image](https://via.placeholder.com/150) Market environment HIGH

If executed well, the model would have great potential in overcoming the current market environment challenges

![Image](https://via.placeholder.com/150) Regulatory MEDIUM-HIGH

Being a service provider to institutional customers would involve a meaningful compliance effort; however, its effectiveness will also depend on the specific elements that are being outsourced

![Image](https://via.placeholder.com/150) Customers and Competition MEDIUM-HIGH

The institutional customer base could be more challenging to manage than individuals; the model can be relatively easily challenged by new entrants
A further important element to highlight is that the models are not necessarily self-contained. The bank can choose to combine several models as part of its operations, and either develop these by itself or by forming various collaborations or conglomerates as outlined below.

Specialists
focus on end client

Specialist “innovators” creating new products and services for clients. They could be self-contained given the lean operating models or leverage “infrastructure platforms” if necessary. Increasing needs for financing will encourage the spread of “balance sheet providers” in the banking sector, in particular in the small- and medium-sized corporate sector where the financing needs are the most meaningful.

Specialists
middle and back office

“Infrastructure platforms” acting as business process outsourcers to other entities and being enablers for startups.
“One-stop-shop advisers” working with other business models such as specialized “innovators” and “balance sheet providers” to take advantage of the products enabled by these groups as well as “infrastructure platforms” to keep costs down.

**Conclusion**

- The future will lead to a disaggregation of the banking value chain, with larger self-contained banks becoming less frequent, and a new range of leaner and more differentiated entities taking their place.
- Customer experience will regain its importance, leading to different strategies to address client needs.
- We expect a higher number of alliances forming between banks and other industry players in order to tackle common challenges.
- Banks will need to consider their strategy and where they will fit within the banking chain of the future in order to be successful in the new operating environment.