BearingPoint® Institute

Five steps for European banks to shape up

Europe's post-financial crisis regulatory regime is evolving fast: our study shows banks have to respond with proactive innovation, not squeezing margins

Banks are falling out of favour with the markets

Since the financial crisis, the price-to-book value of banks has dropped significantly relative to other sectors

Source: Thomson Reuters Datastream

The industry is facing unprecedented pressures, a possible sign of structural changes to come

Capital dilution

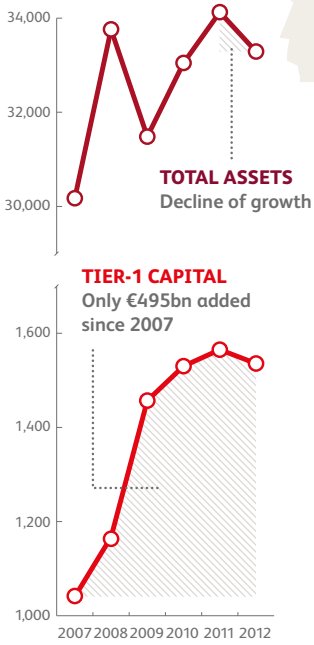
Private and Governmental capital injections proved insufficient to consolidate core equity bases. Less than half of the money injected has gone into capital reserves and, five years on, more is still needed to meet new Basel III requirements

Capital injections

Capital fed to European banks since 2007

Fresh capital needed in light of Basel III requirements

Tier-1 capital and total assets, €billion



Job cuts

Across major European banks

With more lay-offs to come as the industry restructures, many will leave the shrinking sector for good as redundancies outpace new hires by roughly two to one

€7bn lawsuits

Against major European banks since 2009

Meeting the post-financial crisis challenges: five steps for European banks to shape up

How can banks respond to a changing regulatory regime, meet their customer's needs and still turn a profit? The answer lies in proactive innovation, not squeezing margins

Banking is arriving on a new playing field

The past five years have seen some of the most troubling financial times that the world has experienced for nearly a century. Countries, and banks, across Europe have borne the brunt of these challenges, with several requiring bail outs and with many others experiencing double or even triple-dip recessions. The problems were caused in part by regulatory weakness, as a British House of Lords report[1] published in 2008 illustrates:

The consensus is that global macro-economic imbalances and financial innovation – which amplified the consequences of excessive credit and liquidity expansion – together with failures in regulation, supervision and corporate governance, combined to cause the financial crisis.

As a result, the banking industry faces game-changing regulations, based on a fundamental review of financial market risk and driven by an updated international consensus, covering both the scale/scope of banking businesses, and the related

liability to national governments and political aspects[2] (see figure 1).

Significantly increased expectations from both regulators and capital markets are appearing, even as banks struggle with a range of commercial challenges. As well as dampened market growth rates in developed markets and increasing macro-volatility, ongoing challenges include:

The banking industry is arriving on a new playing field and will continue to be less profitable than in the past

Capital pressures

- Heavy financial losses and past burdens, such as large portfolios of non-performing loans (NPL) and goodwill to be depreciated.
- Costs from cutting staff, organisational restructuring, and compliance with new regulation and reporting obligations.
- Substantial jurisdictional risks from increasing willingness to account for past faulty actions. In Europe, this has translated into about EUR 7 billion[3] in lawsuits since 2009, a large part of which has been paid.
- Despite capital injections of some EUR 850 billion, net Tier-1 Capital is only about EUR 495 billion and a further EUR 350 billion of capital appears to be required to assure market liquidity (given the same assets).

Supply-and-demand challenges

- Nation states have been subjected to recessive tendencies, with heavy effects on credit quality and the need for impairments/allowances on balance sheet values.
- Reduction of inter-sector exposure and the run for customer deposits are keeping refinancing conditions highly competitive.

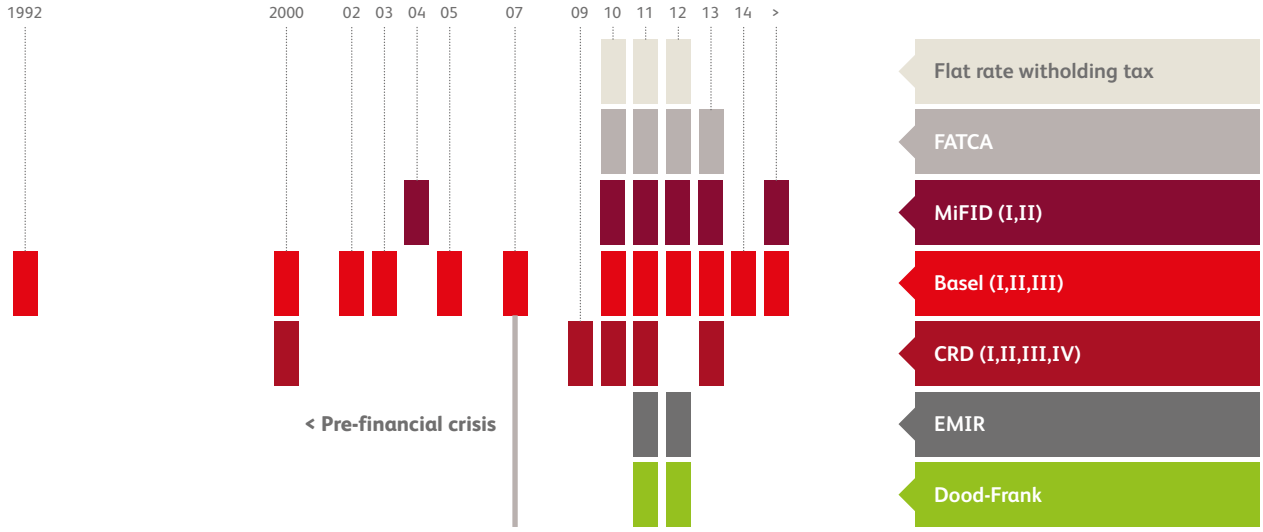
Competitive pressures

- New trade finance players such as insurers, new intermediation channels and alternative routes to market, as well as ICT/mobile payment players like PayPal[4], Amazon[5] and even Bitcoin[6], are all unwelcome distractions.
- While banks currently benefit from looser European monetary policy in terms of liquidity, this drives lower interest margins and interferes with market mechanisms, delaying a shakeout of weaker organisations.

As the banking industry leaves behind this period of heavy financial and reputational loss (the UK trade organisation, the CBI has published a report

Figure 1: The regulatory pressure is increasing rapidly

Banks now face several initiatives that often run parallel to other regulations



that illustrates that graduates are less interested in taking jobs in banks[7]), it is arriving on a new playing field. Bank stocks reflect a pan-industry repricing of banking business values, based on the recognition that the sector has become and, ceteris paribus, will continue to be less profitable than in the past.

The profitability challenge for banks

A main driver for reduced profitability comes from the changing regulatory frameworks that cover the banking sector. Even as banks are forced into a period of introspection (as the challenges that caused the crisis are very hard to attribute to any particular area of governance), they find themselves under increasingly onerous restrictions.

Based around an altered economic–political consensus covering the role, scale and scope of banking businesses and associated state liability, both pan-European and national regulatory bodies are evolving, from hands-off rule-setters to more proactive monitors of good governance.

The resulting regulatory set-up builds in more stringent supervision and restraint of banking businesses, following newly accepted norms, such as:

- enhanced risk awareness (easing of systemic underestimation and underpricing);
- reduced potential state liability and/or moral hazard;
- lowered leverage and size of banks, to reduce systemic importance of single market entities;
- reduced interdependencies within the sector, to enhance stability of financial markets;
- decoupled dynamics between financial markets and real industry;
- eliminated unregulated business activities;
- refocused business scope towards 'vintage banking';
- increased transparency and reporting obligations.

Such stronger regulation significantly affects banks' core business dynamics, as it drives lowered risk-taking abilities and the need to lever down – due to both increased equity and reduced risk/assets.

The asset side of the balance sheet faces increased capital requirements to assure liquidity (including higher requirements on quality of equity), while refinancing challenges on the liability side require a root-and-branch review of refinancing patterns. At the same time, banks are not only looking to manage their own funds, but also to attract equity holders in this increasingly competitive, margin-constrained market.

As intra-sector liquidity transfer is reduced, the need to balance the structural congruency between assets and liabilities has a dampening effect on innovation, particularly around lending. The resulting, more conservative attitude to risk-taking and refinancing puts pressure on margins, characterised by:

National regulatory bodies are evolving from hands-off rule-setters to more proactive monitors of good governance

- larger liquidity, which bolsters a scarcity of liquidity and increased opportunity costs;
- heightened market discipline, therefore structural repricing in debt and hybrid refinancing;
- a run on deposits, due to preferential regulatory treatment, which drives more competition and lower interest margins;
- higher margining and standardisation in over-the-counter derivatives businesses;
- a variety of asset reallocation incentives from capital regimes that favour low-yield instruments, such as government bonds;
- reduced-term transformation.

Larger banks in particular suffer the consequences.

Stronger regulations significantly affect banks' core business dynamics

13.6% Banks average Tier-1 capital ratio in 2012, up from 8.4% in 2006

With regulations based on a maximum leverage ratio, capital charges for systemically important financial institutions (SIFIs)[8] and increased supervisory attention (particularly at an international level), banks have to reconsider their attitude to scalability and size. As a final consequence, increased governance not only adds to operational costs, particularly in the securities businesses, but it takes up valuable executive management time.

The overall impact on the sector – to weaken the ability of banks to act as intermediaries for monetary transmission – is causing a shake-up that is nowhere near finished. The extraordinary aid provided by national governments (bail outs) may have delayed the market adjustment process, but this is only temporary and it muddies the waters, making it hard for banks to set clear strategies and stick to them. We are seeing a number of consequences across Europe:

- Money demand is suffering from credit rationing and repricing (i.e. tightened lending standards) due to the risk aversion of banks.
- Money supply is also facing a market environment with more or less distressed conditions regarding capital markets' refinancing.

Meanwhile institutional investors, such as insurers or pension funds with trillions of euros in funds under management, are under increasing pressure to achieve returns for their clients, to whom they have long-term liabilities. Due to volatility, risk and regulatory considerations we see a strong focus on fixed-income products, such as sovereign bonds – investors are suffering from the effects of monetary policy on interest terms, which are at all-time lows in order to stimulate the credit cycle.

A good question to ask is, 'To what equilibrium of risk/return levels can banking businesses return compared to the past?' This discussion is ongoing in the banking industry – not least because, thus far, banks are seeing very little return on their equity and are a long way from earning what equity-holders expect. It is our view however that the inferior risk/return relationship in banking will persist for some time yet. With regulation as the most important driver, banks are finding it increasingly hard to return their costs of equity[9] while faced with more conservative risk attitudes and eroding margin structures.

Research findings – are banking's glory days over?

How does the new banking landscape appear? While over 6,000 credit institutions exist across Europe, less than 100 make up the majority of banking activity. The BearingPoint Institute has examined the past seven years of performance of these banks: from our research, this report compares the fortunes of 92 banks (representing 84% of the consolidated European banking balance sheet)[10] to look at how risk/return relations look today.

The financial crisis forced an abrupt stop to the growth of the banking sector. In 2006, banks' balance sheets were growing at pace. The financials of our European sub-sample show more or less the same total assets as in 2008. However, in the context of a significantly lower lever:

- Banks have started to increase their capital – average Tier-1 ratio increased from 8.4% in 2006 to 13.6% in 2012;
- Meanwhile, loan to deposit ratios have decreased by about 10%;
- In particular, the inter-sector exposure (domestic and cross border) of average interbank lending (loans to banks/total loans) has reduced from 17% to about 12%.

Figures 2–6 below present an overview of the findings covering the Nordics, Germany, France, the United Kingdom, Ireland and the Benelux countries. The charts plot return on equity (RoE) against the banks' overall risk exposure (incorporating liquidity risk, credit risk, market risk, refinancing risk, regular operational income volatility and solvency) based on comparisons between 2006 and 2012 data, with arrows to indicate the transitions between the two.

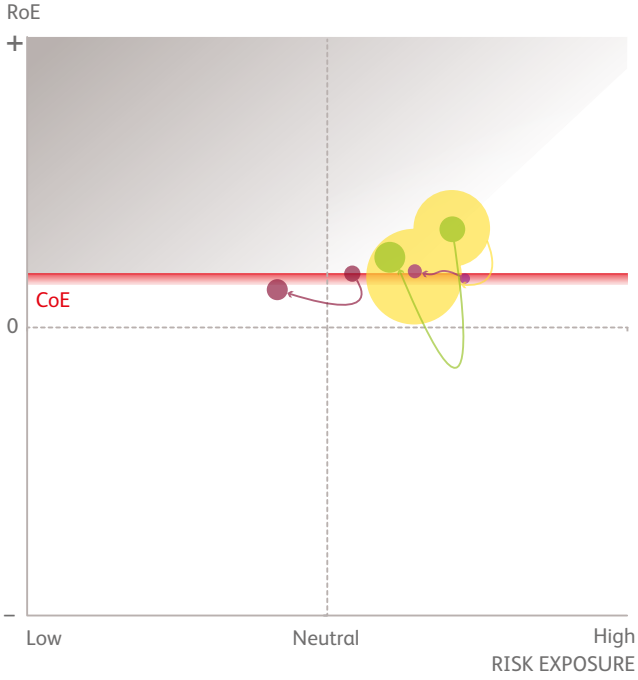
As the charts below show, the 'new banking reality' involves a substantial change in the relationship between risk and return for banking businesses, with overall performance far inferior than before the financial crisis. Across the board we see banks struggling with heavy losses in economic substance and reputation, even as they carry historical burdens such as large portfolios of non-performing loans (NPL), goodwill to be depreciated, and so on.

Legend for figures 2–6

- TOTAL VALUE OF ASSETS
- COST OF EQUITY: 8 –11%
- DARKER AREAS SHOW MORE PREFERENTIAL RISK/RETURN RELATIONSHIP
- PRIVATE BANKS
- SAVINGS BANKS (GROUPS)
- PRIVATE BANKS HOLDINGS
- COOPERATIVE BANKS (GROUPS)
- COOPERATIVE CENTRAL INSTITUTIONS
- SAVINGS CENTRAL INSTITUTIONS

Figure 2: Nordics – classic banking makes sense

The Nordics' banking sector appears quite homogenous with modestly diversified, universal banking institutions promoting a more 'classic', retail/merchant-oriented banking business with less investment banking.



+ Nordic banks have remained profitable, benefiting from a relatively sound economy and low levels of non-performing loans (NPL)

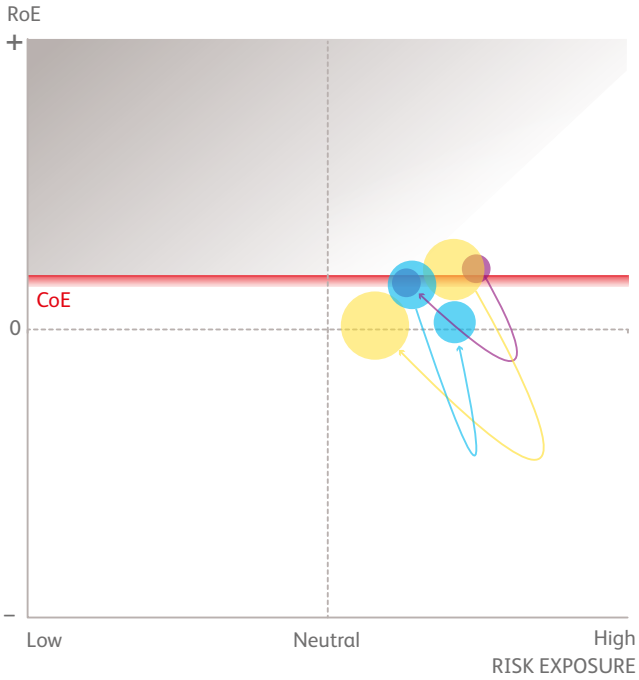
+ Nordic banks have done well in improving cost efficiency (both branch and staff utilisation) and were able to lever relatively high loans-to-deposits ratios over capital markets

– Mostly focused on domestic markets; risk adversity could be a double-edged sword

– May be hit by increased refinancing costs, despite good credit standing

Figure 3: Germany – not all banks are the same

The German banking sector shows a variety of business models, in terms of differing business focus, levels of diversification and risk-affinity. The three-pillar system – with private banks, savings banks and cooperatives – is deeply rooted here.



+ Moderate risk-affinity: German banks were generally unprofitable during the crisis, but the majority have turned around, benefiting from a relatively sound economy and mid-to-low NPL ratios

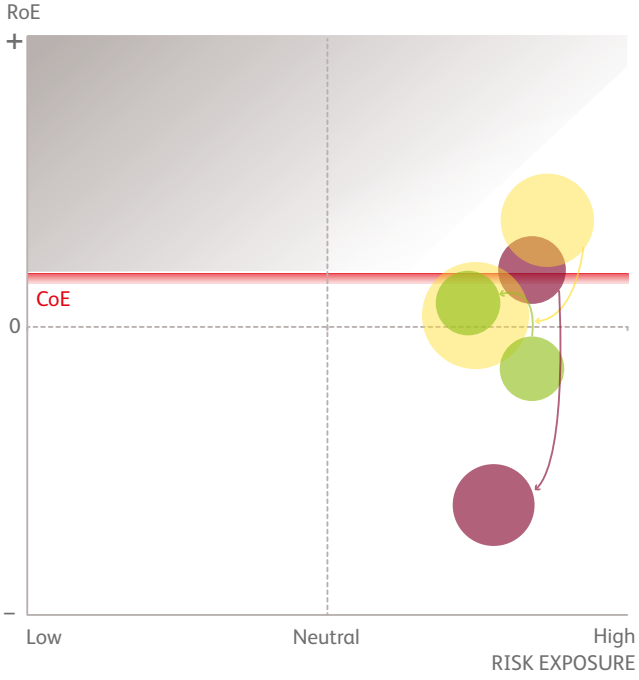
+ Good credit standings: lower debt leverage than, say, the Nordics' banks

– High operating costs: further improvement in branch/staff utilisation necessary

– Landesbanken are searching for valid/sustainable business models

Figure 4: France – too big to fail

France has a comparably large banking sector that is dominated by five banks committed to their universal banking model. All but one are well-diversified institutions with global reach and intense capital markets activities. Structural cost reduction and retail banking transformation are on their agenda.



+ French banks are less risk-averse compared to the rest of Europe

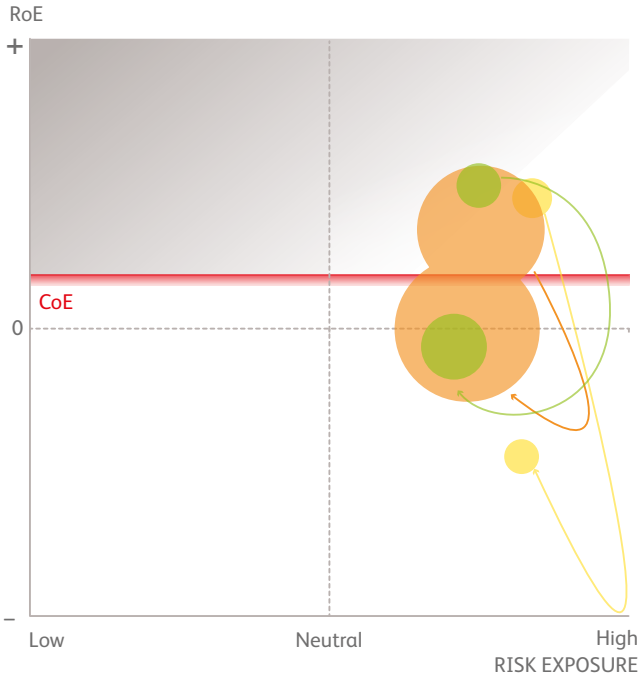
+ There is great potential for consolidation/streamlining in terms of branches, employee numbers, and so on

– Levels of return do not correspond to risk-affinity. Structural underperformance is also reflected in comparably low price-to-book ratios

– Further slowdown of economic cycle in France/Europe might hit the banking sector dramatically

Figure 5: UK and Ireland – global banking

The UK has large, globally active and highly diversified UK bank holdings, which have been quite expansive (goodwill in relation to common equity); meanwhile Ireland is less diversified and has a higher geographic focus.



+ UK and Irish banks have seen significant and continuous improvements in branch/staff consolidation

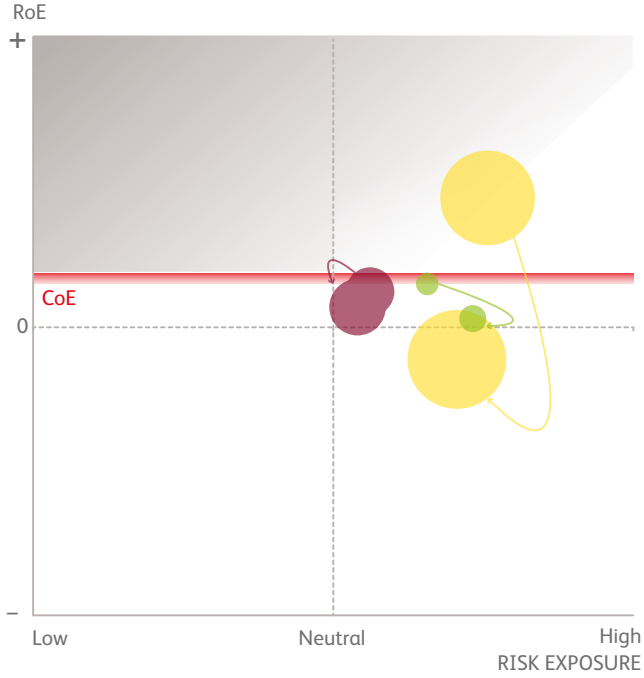
+ Regional diversification (such as Asian businesses) has proved beneficial during the financial crisis and continues to provide sustainable business opportunities

– In Ireland, short-term thinking led Irish banks into disproportionate risk-taking in their domestic credit business

– NPL credit risks are disproportionate to the average net interest margin (NIM) the UK/IRL sector is earning

Figure 6: Benelux – a major reshuffle

Belgium, the Netherlands and Luxembourg have a few larger banks, which tried to expand on a global scale in both banking and insurance. Due to over-optimistic leverage/expansion, the majority of these organisations needed to be rescued by government bail outs.



+ Benelux banks have done well in improving cost-efficiency (both in branch and staff utilisation) – there is an ongoing opportunity for thorough slimming under a governmental shield

+ Rabobank presents a good example of stability using the traditional, cooperative model

– Dutch banks suffering from increased in NPL ratios due to the bursting of a Dutch mortgage bubble and the wider economic slowdown

– Large banks needed state rescue; they were nationalised during the financial crisis, leading to increased public debt and dampening the economic recovery

Options for cost efficiency and profitability

With increased refinancing costs, dampened sales, and growing competition and regulatory momentum, banks face a severe dilemma of having to be risk-averse to conform with regulation and rating agencies, which erodes sales potential as a result, leading to a drop in investor confidence and the banks' valuation.

Until recently, banks have generally been levering down (through the increase of capital and the reduction/realignment of assets) and cutting costs: they have been acting in a more risk-averse and defensive manner. Internally, banks also face a 'cultural challenge' to find a balance between incentivising (at times, extremely) high yields for banks, and minimising the consequent risks faced by society as a whole.

So, how can the industry balance primarily risk-oriented drivers for contraction with profit-oriented drivers for growth, to comply with the competing demands of regulators and investors? The most obvious option is to look for efficiency savings.

Increasing cost efficiency through economies of scale

In order to increase profits in an environment of higher refinancing costs and lower scale, either costs must be reduced and/or costs have to be passed on disproportionally to customers. To put this in context, it is important to acknowledge pre-crisis sentiment – banks felt they had to become larger in order to reduce costs.

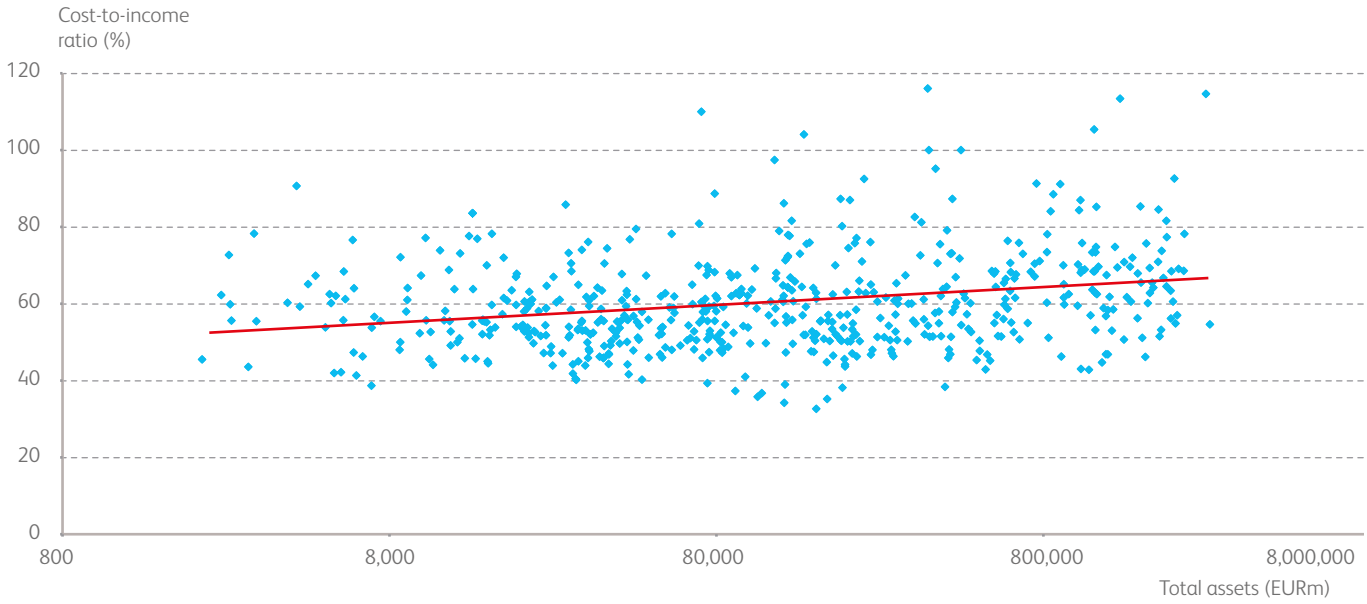
Post-crisis regulation and economic policy unfairly restricts larger banks and international expansion, however. This contradicts elementary economic principles and notions of profitability – usually businesses strive to grow, to increase market share and achieve economies of scale.

But what happens in reality? Does size matter in banking, are larger banks more profitable? We can turn to our research to answer this question, using 'cost-to-income ratio' (CIR) to represent the operational profitability of a bank, measured as:

$$\frac{\text{(operating costs)}}{\text{(operating income before provisions for credit risks)}}$$

Figure 7: Larger doesn't always mean more profitable

CIR vs total assets



From the research we find that banks are not necessarily able to decrease their costs by increasing scale (see figure 7). On the contrary, smaller/mid-scale banks appear to be very cost-efficient. Why is this? As we know from many BearingPoint projects, one reason arises from the inflexibility of large IT architectures, and the resulting costs when anything has to be changed. As banking businesses increasingly operate in a dynamic context, large IT architectures and support organisations create an increasing burden.

This might not present too much of a dilemma. Given that the political consensus is to restrict bank sizes, coexistence with smaller and profitable organisations is possible. All the same, it would be usual for an industry 'on the ropes' such as banking to experience significant consolidation. Businesses that survive accumulate the assets of those that do not, and so strengthen their positions and improve their respective profitability by taking the opportunity to increase margins in a less competitive market, even where this is detrimental to customers.

Despite its currently low profitability, we should not expect the banking market to clear up rapidly – monetary policy is impeding competition and delaying any such shakeout. At the same time, we acknowledge that the relation between size and profitability is not so evident. So, where else can cost efficiency be found? Should banks look at reducing their footprint?

Banks are not necessarily able to decrease their costs by increasing scale

Increasing cost efficiency through cost reduction

Given that scaling up is not a valid option for cost efficiency, banks are looking at how they can improve profitability by reducing costs from their own internal structures. Due to the relative significance of staffing and branch networks on banks' balance sheets, they both present likely candidates for cost reduction.

Considering staff reductions (CIR vs assets per employee)

CIR does not appear to decrease with employee utilisation, quite the opposite in fact (see figure 8).

Figure 8: Staff reductions do not necessarily result in efficiency savings

CIR vs assets per employee

First, this is due to the structure of higher-levered business models – managing money does not have to be labour intensive. Equally, there is no clear evidence that retail businesses benefit significantly from such measures; meanwhile, lay-offs introduce severance payments and can cause restructuring costs, which reduce any benefits from such a policy and potentially affect income. As a result, based on this research, we do not consider lay-offs to be a significant cost-efficiency lever.

Cost savings can be made from cost reductions, but not necessarily from people

Considering branch consolidation (CIR vs non-staff operating costs per branch)

As we can see in figure 9, CIR appears to decrease with non-staff operational expenditure per branch. So branch consolidation or streamlining could be a powerful means to reduce CIR.

While this may be true, banks would be wise to consider branches in terms of their broader strategies, for example to act as sales channels for new products[11] or offer direct contact points.[12] Banks have an increasing number of options for service provision – including, for example, the provision of services via post offices or petrol stations as well as via online and other digital channels – so branch consolidation decisions should take place within the context of a broader, cross-channel strategy.

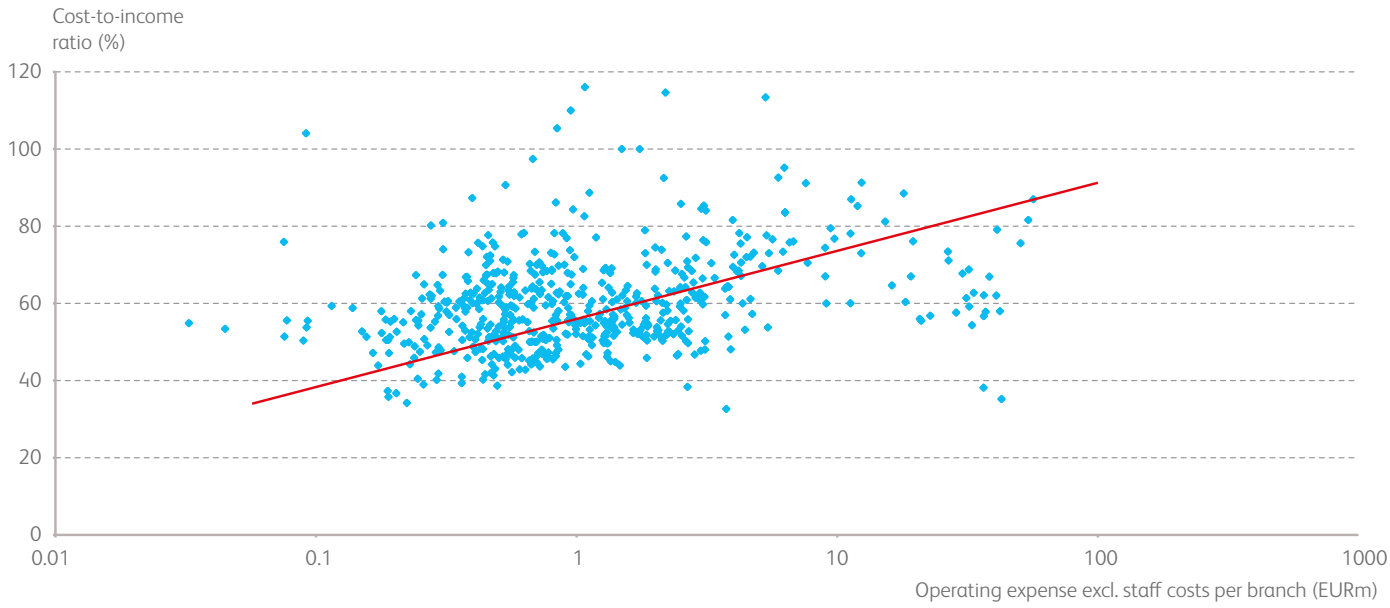
The bottom line is that cost savings can be made from infrastructure reduction, but not necessarily from people. Equally, while cost reduction can be seen as a necessary adjustment process in the short term, it can neither counter the effects of weakened income streams, nor provide an ultimate remedy for growth.

Diversification – opportunity or risk?

With the above conclusions in mind, will value be returned based on diversification of business models? From our research we can calculate a notion of diversification on the basis of proportions of three regular income sources in total income across three years – 'net interest

Figure 9: Branch streamlining is productive but may clash with strategy

CIR vs non-staff operating costs per branch



income', 'net fee and commission income' and 'trading income'. Using this method we can compare diversification of financial activities with the stability of CIR – see figure 10 – a correlation that we regard as proportional to the stability of a business model.

The figure shows that private banks – the most heterogeneous subset (excluding Swiss asset managers) – appear to benefit from diversification in terms of lower CIR volatility.

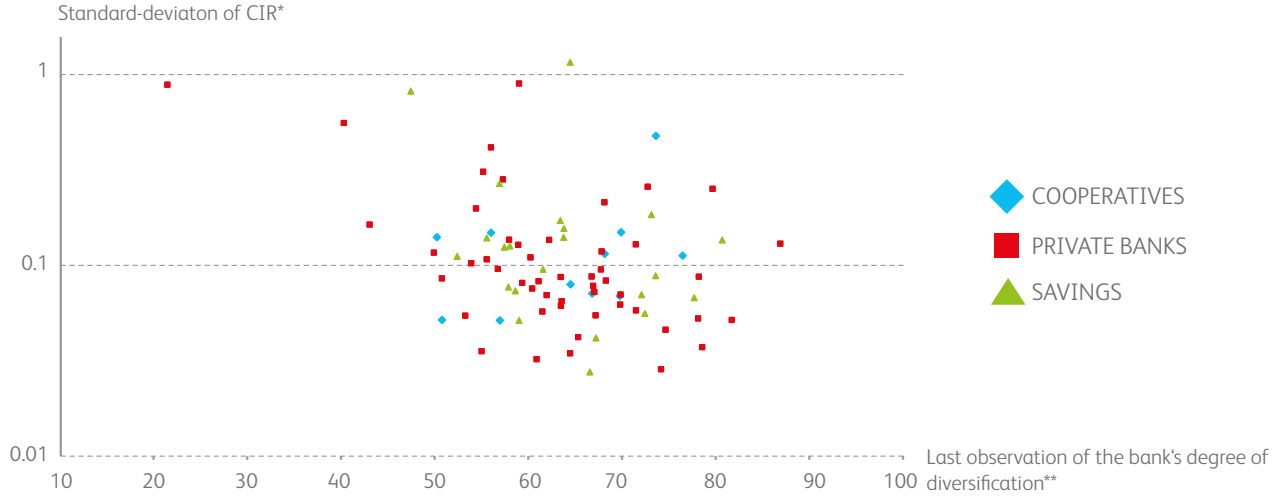
Savings organisations also show a positive relationship between diversification and business model stability. Although, the final group – cooperative organisations – do not appear to benefit from a higher diversification of their activities. This is most likely because this strategy lies outside of their core competencies/abilities.

Overall, diversification can yield business model stability – higher guarantees of return over time. This actually provides an argument for the universal banking model, that banks should provide a comprehensive range of services.

Diversification can yield business model stability, banks should provide a comprehensive range of services

Figure 10: Diversification benefits private and savings banks but not mutuals

CIR volatility vs diversification by bank type



* calculated over the entire observation period of a bank, divided by the mean CIR over the same period
**which had been calculated on a 3-year trailing basis with reference to the portion of net interest income, net fees and commission and trading income in total income)

Sustainable profitability through innovation

From our research we have seen that banks have options when it comes to stabilising their businesses – not least through branch consolidation and diversification. However, these do not offer a path to growth, which must come from income.

Banks have options for stabilisation. However these do not offer a path to growth, which must come from income

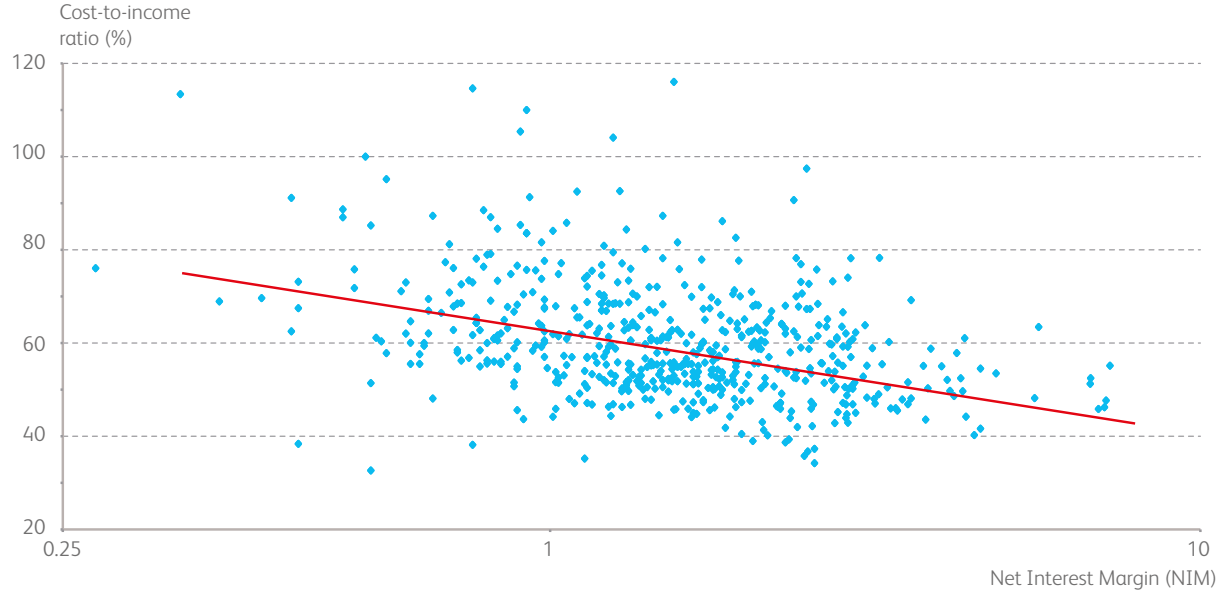
One measurement of income is using 'net interest margin' (NIM). Figure 11 shows the inverse relationship between NIM and CIR, which indicates how NIM is strongly linked to the overall operational profitability of a bank – a higher NIM does not correspond to proportionately higher costs. Banking businesses can strongly differentiate here and, accordingly, they should follow more aggressive strategies that focus on increasing NIM, by adding value for customers.

From our research we also know that NIMs have been dropping across the board and are converging across regions. It is not obvious when and to what extent NIMs will recover, which in turn puts pressure on bank profitability. NIM convergence also implies pan-European rationalisation of bank dispositions – over time, an increasing homogeneity of banks across the region.

The bottom line is that economies of scale in commoditised, low-margin products cannot offer a sustainable model for banking businesses. In order to counter this, banks need to look for differentiation, to identify new sources of value through innovation and to target these areas even while they look for efficiency savings elsewhere. The industry needs to switch from a defensive, risk-handling mode to a more offensive business-development focus, even as continued deleveraging/contraction pulls the rug out from under its feet.

Figure 11: Higher margins are not directly correlated to higher costs

CIR vs net interest margin (NIM)



Banks must put their best foot forward

New, innovative, higher-value products offer increased margins and therefore a greater opportunity for growth. But where can this innovation come from? Based on our experience of working with banking clients we recommend five main actions (see figure 12). Each one has different levels of sustainability and business impact, starting with improving the cost structure and leading eventually to innovation itself.

1. Improving cost efficiency

The lowered risk/return relation in banking businesses increases cost pressure and facilitates the need for gaining operative efficiency. More than ever, banks must challenge existing cost structures in order to stabilise operating profits.

Challenging existing processes and cost allocation often proves beneficial to cost efficiency as it enables resources to be more appropriately targeted. One option is the outsourcing of non-critical business processes – but this requires a comprehensive view of existing processes, to permit identification of processes (or process elements) that can be outsourced meaningfully.

Proposition: Employ cost reduction as an effective strategy, but recognise it is not an answer to all problems.

2. Standardisation and/or industrialisation

The cost problem needs to be handled strategically. To make a real difference, banking businesses need to address their often-quoted lack of standardisation in terms of processes, products and infrastructure. Where such activities have been started (for example, in standardised product areas), they can be built on with further streamlining of processes and infrastructure, enabling better use of automation.

The goal of such initiatives should be to deliver more process-oriented and modular structures, as these enable individual elements of the operative service-chain to become more scalable, predictable and cost-efficient, resulting in higher productivity and faster time to market. Moreover self-contained, modular business models can evolve – such initiatives lead, finally, into the refinement of the business model focus and the revaluation of the vertical range of integration.

Proposition: Process orientation and a modular approach enables specialisation and allows for further business model transformation.

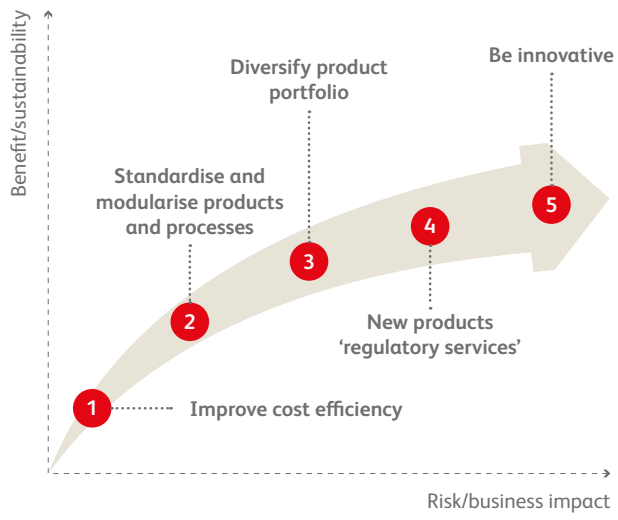
Process orientation and a modular approach enables specialisation and allows for further business model transformation

3. Product portfolio optimisation – diversification

Besides risk management improvements, the broadened and more stringent nature of regulation implies margin pressure on many banking businesses. Diversification offers a route to continued stability of profits, and therefore reduces overall business risk, particularly for private banks and savings organisations.

Figure 12: How banks can evolve and innovate

Five stages for moving the bank forward



In response, banks can first assess the effects of regulation on different businesses in order to understand the nature of their existing portfolios. This provides a foundation to adjust portfolios with a view on their own core competencies.

Proposition: Revaluation and optimisation of the product portfolio is a necessary reaction to regulatory pressures.

Revaluation and optimisation of the product portfolio is a necessary reaction to regulatory pressures

4. Embrace opportunism – even regulation can yield new products

The dynamically evolving regulatory environment does not only affect margins. It transforms business dynamics in many banking industries, and impacts on processes and their costs, IT and other infrastructure. While this creates challenges for the sector, it opens up opportunities for new products and services to be created.

Banks in a position to respond to the changing market ecosystem through faster product time to market may be able to steal a march on the competition. This does not have to be about 'pure' innovation – rather, understanding the market direction and reacting accordingly, which may even help to drive the reorganisation of the market itself.

For example, many banking clients are equally affected by new regulations. Why not offer new services to clients to better cope with their regulatory requirements, say by offering clearing broker services or reporting services? Or, as we have seen with Crédit Agricole[13], why not build solutions based on 'opening' access to customer data and using mobile applications?

Proposition: Use the new regulatory environment as a basis for new services and business cases – engage proactively with new regulation to identify underserved opportunities.

5. Business innovation means going beyond traditional market areas

Every industry has a tendency to commoditise, so it is up to banks to keep ahead of the competition. Ultimately, banks wishing to survive in the long term will have to create new products that add significant downstream value to their customers.

Increased specialisation, well-defined modularity, more flexible processes and appropriately standardised interfaces all provide a foundation for business and product innovation. This includes business processes running across company borders, with both internal and external service virtualisation and open innovation – opening up services so that other can build on them.

Proposition: Develop the income side of the business by creating new, high-margin products focused on reaching new markets.

Not consolidation, but reorganisation of (trans-industrial) value chains

As we have mentioned, a major factor in the changing banking landscape is the increased competition from lateral industries.In a previous *BearingPoint Institute* paper, for example, we presented an analysis of how the mobile payments industry is evolving[14], bringing in new players from the technology and telecommunications industries; in another we discuss the increasing role of insurers in infrastructure investment[15].

While banks struggle to act as a channel for monetary transmission, even as regulations and monetary policy evolve in kind, this climate stimulates alternative intermediation channels that gain ground through technological innovation and operation in less regulated areas. Examples include:

- Increasing emergence of new players in sales financing – large corporations that accumulate large financial reserves and have good credit standing can increasingly compete in refinancing conditions. Automotive firms even securitise and sell these credits, so they do not have to refinance them with their own credit standing.

- Competition from ICT players, which increasingly penetrates payment-handling aspects of the banking business (mobile payments, for example), which accumulates deposits as a result (e.g. PayPal).
- Insurers investing in new financing vehicles, such as credit funds (a new trend in Germany/ Continental Europe) thereby augmenting or even eliminating banks as financial intermediaries.
- Online retailers are testing their own currencies – for example, Amazon.[16]
- 'New' currencies are emerging, such as Bitcoin.[17]

So, what do banks of all shapes and sizes need to do to start on the right foot and strengthen their market positions? The answer cannot be to ignore or to fight against such developments. While the involvement of new players may be seen as a risk to the traditional banking industry, it also creates a significant opportunity – to engage with lateral industries and use integration points to develop the higher-value, higher-margin products that both industry and customers need so much.

To engage with this opportunity requires banks to open up. In practical terms this means:

- Making business processes, business models and internal value chains more open for innovation.
- Reviewing sourcing strategies, and engaging more directly in external partnerships and value chains to add value to commodity products.
- On a technological level, opening APIs to existing systems and working with open-data platforms, while looking at new advances in technology – some refer to this as 'open innovation'.
- Focusing on customer interaction and how services can be enhanced to increase customer value.

Overall, these are simply enablers or prerequisites for the bigger goal – to put banks into a position where they can join a broadening, diversifying ecosystem of networked organisation and dynamic value chains. From our perspective this means looking outward, to learn from other industries that are more advanced in process automation. Like it or not, the banking industry is far behind in this endeavour. In order to move forward, banks need to rebalance the banking agenda at a strategic level and change their behaviour from within.

Delivering a foundation for growth

There is currently a sea change occurring in the banking industry. Banks can no longer act in isolation on the principle that bigger is in some way better. We know from our research that this is not the case. Meanwhile markets and customer behaviours are getting increasingly dynamic, so banks have to make the decision as to whether they respond to this new context.

Cost-efficiency remains on the agenda for the majority of banks, to satisfy investors' return-on-equity demands. However, going on as usual and waiting for market consolidation and the rejuvenation of competitive conditions should not be an aspiration for the industry. The regulatory momentum against the size and scale of banks means that the level of fragmentation will not materially decrease; meanwhile margins will remain low, so economies of scale will not be the remedy for the industry.

Banks have to make the decision as to whether they respond to this new context

From our research we recommend five actions, which lead from dealing with the immediate issues to delivering a platform for innovation and growth:

1. Employ cost reduction as an effective strategy, but recognise it is not an answer to all problems.
2. Process orientation and a modular approach enable specialisation and allow for further business model transformation.
3. Revaluation and optimisation of product portfolios are necessary reactions to regulatory pressures.

KEY TAKE-AWAYS

- The days of guaranteed returns for banks are over. Market dynamics and regulations have created a new landscape in which banks have to work harder to generate revenues.
- Cost efficiency is a necessary short-term goal – but this is better achieved by reducing infrastructure than cutting staff.
- Counter-intuitively perhaps, bigger no longer means better in banking terms, due to the changed dynamics of liquidity.
- In order to achieve innovation opportunities, banks will have to get their own houses in order and create standardised, modular foundations for agile business strategy, faster product development and efficient growth.

WATCH

Scan this page with Layar, or visit www.inst.be/003PFC, to watch the author's interview.

SCAN WITH layar

4. Use the new regulatory environment as a basis for new services and business cases – engage proactively with new regulation to identify underserved opportunities.
5. Develop the income side of the business by creating new, high-margin products focused on reaching new markets.

In order to respond to the structural profitability challenge, banks will have to find new answers by innovating and creating customer value. Technological advancements offer new business opportunities for agile/dynamic players across industries – while other industries have continuously reinvented themselves, the banking sector has remained backward and now lags far behind.

If banks wish to assure their primacy in financial intermediation, they will have to deliver ground-breaking innovation and focus on the creation of new customer value. Of course, regulatory constraints will impact their ability to innovate – even market leaders will not have an easy ride. But simply focusing on increasingly tight margins only leads to decline. Breaking out of this spiral will be a challenge for banks. The scale of the challenge, however, is more than matched by the opportunity.

About the author

Dr Robert Bosch is a Partner at BearingPoint and part of the Banking & Capital Markets Group in Germany. His main focus is at the intersection of Business Strategy, Capital Market Processes and Capital Market Compliance where he has been advising clients in Europe, Middle East and Asia for more than 15 years. He has published several thought leadership articles on capital markets topics, focusing lately around EMIR and the Financial Transaction Tax. Robert Bosch holds a PhD in Banking and Finance from University of Erlangen-Nuremberg.

robert.bosch@bearingpointinstitute.com

Project Team

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DEN HERAUSFORDERUNGEN NACH DER FINANZKRISE BEGEGNEN: FÜNF SCHRITTE, WIE SICH EUROPÄISCHE BANKEN NEU AUFSTELLEN

Die europäische Bankenlandschaft präsentiert sich jüngst als Objekt eines hochkomplexen und im Schatten der Verwerfungen der letzten Jahre stetig wachsenden Netzes an Regularien. Mit Blick auf immer neue Anforderungen und Restriktionen stellt sich die Frage, wie sich die Industrie diesen Herausforderungen stellen und den Verfall ihrer Eigenkapitalwerte stoppen kann.

Im Rückblick auf die letzten sieben Jahre beleuchtet BearingPoint die Geschicke 92 in Europa ansässiger Banken.

Die vorliegende Studie liefert einen Eindruck darüber, wie sich die Bankenlandschaft über die letzten Jahre auf ein inferiores Risiko-/Rendite-Niveau bewegt hat. Das Ergebnis ist eindeutig: ob schrumpfender Margen und steigender Eigenkapitalanforderungen ist die Hebung von Kosten-Effizienzen das erste Mittel der Wahl, um überhaupt noch angemessene Eigenkapitalrenditen zu erwirtschaften. Mit Blick auf eine nachhaltige Perspektive in einem immer dynamischeren Umfeld hingegen ist ein offensiverer Umgang mit Innovation und Wertschöpfung von Nöten.

BANQUES EUROPÉENNES : CINQ CHANTIERS POUR RENOUER AVEC LA PROFITABILITÉ ET LA CROISSANCE

Au sortir de la tourmente financière de ces dernières années, le secteur bancaire européen est confronté aux exigences croissantes des régulateurs. Comment ce secteur peut-il aujourd'hui endiguer le recul des résultats et la détérioration des valeurs boursières ?

BearingPoint a analysé la performance de 92 banques européennes, représentant 84% du bilan bancaire européen consolidé, au cours des 7 dernières années. Cette étude compare leur situation et analyse les impacts du nouvel environnement bancaire européen.

Elle présente les approches mises en œuvre pour pallier la baisse sensible des profils rendement/risques au cours des 5 dernières années. La conclusion est claire : au-delà des résultats à court terme que peuvent permettre les réductions de coûts, les banques doivent identifier les opportunités d'innovation et offrir plus de valeur à leurs clients.

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