WHAT YOU NEED TO KNOW

BANKING

Trends in the Global Banking Industry 2013

Key business trends and their implications for the global banking sector

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1. Highlights

The banking industry experienced a strong recovery after the worst of the financial crisis, but continued to be weighed down due to the ongoing Eurozone crisis and concerns of sluggish growth in the United States. An evolving banking landscape in emerging economies (especially China and Latin America) is expected to transform the banking industry in the future. Meanwhile, regulations continue to evolve and create an ever-tightening regulatory environment for the banking industry.

Assets of the Top 1000 banks[1] globally grew by 4.9% in 2012 and registered a growth across all regions in 2012, except in Europe where asset growth was down 0.5% due to concerns about Eurozone debt. The Latin America region registered an impressive growth of 20.5% in assets in 2012, as compared to the other global regions. This resurgence of the economies in the region was driven primarily by rising consumerism and financial inclusion.

Pre-tax profitability of the banking sector has witnessed a moderate growth of 4.6% during 2011–12. This growth has been largely driven by the emerging economies while the profitability of European banks has continued to be negatively impacted due to the Eurozone crisis.

For banks, top priorities include regulatory compliance, improving asset quality, enhancing customer centricity, focusing on digital convergence, and tackling competition from non-banks. Banks are therefore making business and technology investments to change their business models to comply with new regulatory requirements, enhancing capital adequacy, rolling out new channels such as social media, and leveraging customer data analytics and predictive analytics to enhance customer understanding and prevent fraud.

1 The analysis presented here is based on the Top 1000 banks for the year 2012 from The Banker Database. Years represent the calendar year. For example, 2012 represents the period from January to December 2012. For global analysis, banks that represent 75% of the asset base of the Top 1000 banks globally were selected for each year for global analysis from The Banker Database. For regional analysis, data on banks representing 75% of the asset base of a region's banking sector for each year were selected.

2. Introduction

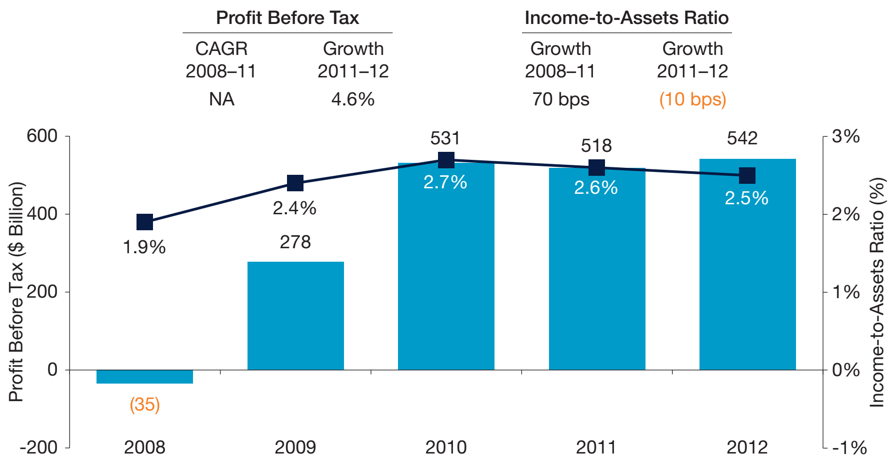
The ongoing crisis in the Eurozone region, coupled with new regulations aimed at enhancing liquidity and risk management, is expected to impact the cost and profitability of banks globally in the near term.

2.1. Global Banking Industry Overview

The financial crisis severely impacted the asset and profitability growth of the global banking sector, which started to recover during 2009 and 2010. The growth rate of assets for the Top 1000 banks grew by 5.9% during 2009–11, reaching well above the pre-crisis level. However, during 2011–12 the growth moderated to 4.9% due to the ongoing Eurozone crisis, which was to some degree compensated by the growth of assets in the Asia-Pacific and Latin American regions.

Profits-before-tax (PBT) of the banking sector also witnessed strong growth during 2009 and 2010. The PBT of the Top 1000 banks increased by $553 billion between 2008 and 2011, and further increased by 4.6% in 2012, primarily due to the efforts taken by the banks to reign in their costs and disposition of non-core assets and unprofitable assets. However, due to the effects of the Eurozone crisis, European banks faced significant pressure regarding profitability.

Exhibit 1: Profits-Before-Tax ($bn) and Income-to-Assets Ratio (%) of Top 1000 Global Banks (by Assets), 2008–2012

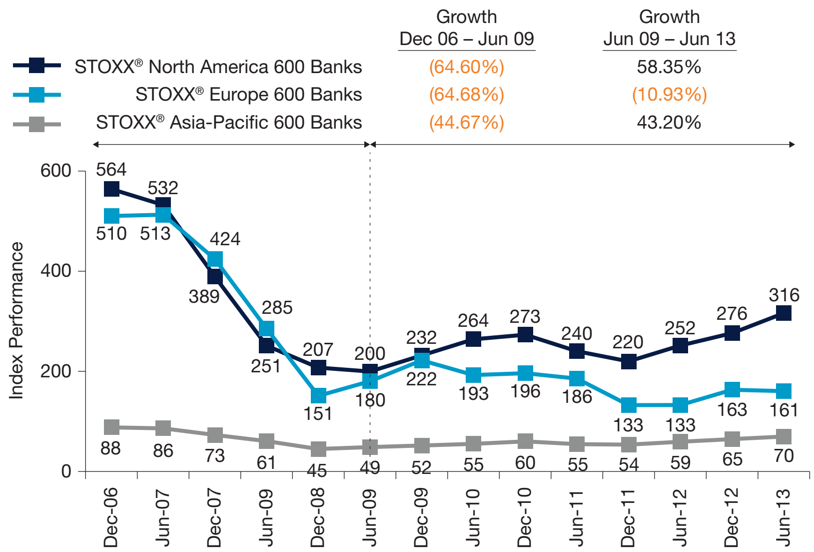


Source: Capgemini Analysis, 2013; The Banker Database, July 2013

The financial crisis underscored the sharp differences in the performance of the banking sector across emerging and developed markets. Emerging markets such as Latin America and Asia-Pacific remained resilient to the crisis in contrast to developed markets where the banking sector experienced sharp losses. The income-to-assets ratio of top global banks declined by 10 basis points in 2012. Although Europe had a huge 45% share of total assets, its smaller share in total pre-tax profits (8%) was a result of significant losses and write-downs from the ongoing Eurozone crisis. On the other hand, the Asia-Pacific region had a 37% share in total assets but 62% share in total pre-tax profits due to strong macro-economic fundamentals. North American banks had a 16% share of total assets but a share of 24% in total pre-tax profits, as most of them continue to improve their profitability after the subprime crisis.

In 2012, banks were impacted by the strong economic headwinds, heightened regulatory pressure, persistently high cost structures, and low customer trust. Market volatility and Eurozone debt concerns continued to weigh down the underperforming European banking sector index. After the financial crisis, the banking sector had come under heightened regulatory scrutiny, which remains a key concern for the industry as regulatory reforms continue to emerge. Imposition of higher risk management standards, curtailment of proprietary trading activities, heightened scrutiny of business models, imposition of more stringent capital adequacy norms, and increased reporting requirements have adversely impacted the profitability and growth prospects of the banking industry.

Exhibit 2: Bi-Yearly Closing Banking Indices, Dec 2006 – Jun 2013



Source: Capgemini Analysis, 2013; www.stoxx.com, July 2013

In today's context, risk management and the evolving regulatory landscape remain the key focus for banks. Emerging priorities include reducing unproductive assets from non-profitable segments and geographies, and focusing on core business areas to improve efficiencies. Banks globally are under increased scrutiny due to recent cases of financial fraud. Another challenge is the threat from non-banks (such as retail chains, non-banking financial services companies) that are increasingly emerging as potential competitors to traditional banks.

Banks in emerging markets (China, India, and Brazil) have grown at extraordinary rates in recent years due to financial inclusion of the bankable income segment.

2.2. Financial Performance of the Banking Industry[2]

Assets of the top banks grew across all regions in 2012, except in Europe where asset growth was slightly down by 0.5%. The Latin America region registered an impressive growth of 20.5% in 2012, as compared to the other regions. This resurgence of the economies in the region was driven primarily by rising consumerism and financial inclusion.

The banking industry assets in the emerging markets of the Latin America region and Asia-Pacific grew the most in 2012, at 20.5% and 9.5%, respectively. The key reason for growth in emerging markets such as China, India, and Brazil can be attributed to financial inclusion of the "bankable" income segment. In contrast to this, while North America grew by 6.1%, during the same period Europe declined marginally by 0.5%.

In terms of operational efficiency, the banking industry experienced very contrasting results. Return on assets (ROA) for top banks in Europe and Latin America declined in 2012, but improved marginally for banks in the Asia-Pacific and North America regions. Emerging market banks led the way on ROA where it remained highest for Latin America at 1.6%, followed by the Asia-Pacific region at 1.1%. The ROA for top global banks in the Latin America region decreased significantly by 25 basis points in 2012, which can be primarily attributed to the strong growth in the assets of the banks compared to profitability.

On the other hand, the ROA for European banks declined by nine basis points in 2011, due to substantial losses and write-offs suffered from the impact of the Eurozone crisis. This led to a decrease in the assets along with the profitability, as most banks had substantial exposure to sovereign debt held by governments. The ROA of banks in North America witnessed a marginal increase of four basis points, as the economy started recovering in 2012.

Cost-to-income ratios decreased for banks across all regions except for the European region, where the ratio increased in 2012. The cost-to- income ratio for North American banks decreased by 0.4% points in 2012, to reach 67.8% compared to 68.2% in 2011. This decrease was primarily driven by efforts taken by banks to reduce their costs along with the increase in profitability. But the cost-to-income ratio for North American banks is highest compared to other regions due to several ongoing and upcoming legislation, such as Debit Interchange regulations (part of the Dodd-Frank Act) and Basel III, which are keeping operating costs higher for banks. The cost-to-income ratio for European banks increased by 4.3% points in 2012, to reach 64.2% compared to 59.9% in 2011, reflecting the impact of the ongoing regulations and substantial write-downs by major banks. In 2012, banks in emerging markets observed a decrease in the cost-to-income ratio of 10% points and 5% points for Asia-Pacific and Latin America, respectively. The decrease in these regions can be attributed to the improving economic conditions leading to higher operating incomes.

2 All numbers highlighted in this section are based on Capgemini Analysis, which was conducted on the data retrieved from the The Banker Database of the Top 1000 global banks (based on assets). Numbers pertaining to specific regions are based on the data available in The Banker Database for banks from that region, which figure among the Top 1000 banks (based on assets)

Strengthening the capital positions of banks has been a key regulatory focus for authorities after the financial crisis. In order to comply with the new Basel III requirements, top banks across all regions are making efforts to improve their Tier 1 capital ratios. While European banks have registered the highest improvement in the Tier 1 capital ratio in 2012, they are still lagging behind other regions.

Tier 2 capital[3] ratios realized a marginal change in 2012, except in Latin America, where this measure increased considerably, as the major Brazilian banks had made significant issuance of Tier 2 capital before the Central bank enforced issuance of Basel III compliant debt. With the new capital requirements proposed by the Basel III norms (expected to be phased in by Jan 2015, post the transition period of 2013-15), there is an expectation that banks will increase their Tier 1 capital ratio from the current 4% to 6% by 2015, thus putting further pressure on the bottom line. In order to ensure that they are in compliance with regulations, banks have started restructuring efforts to convert their hybrid capital (a part of Tier 2 capital) to core capital and deleverage their balance sheets.

Exhibit 3: Capital Phase-In Requirements under Basel III

	2013	2014	2015	2016	2017	2018	2019
Min. Common Equity Capital Ratio	3.5%	4.0%	4.5%	4.5%	4.5%	4.5%	4.5%
Capital Conservation Buffer	-	-	-	0.625%	1.25%	1.875%	2.5%
Min. Tier 1 Capital	4.5%	5.5%	6.0%	6.0%	6.0%	6.0%	6.0%
Min. Total Capital	8.0%	8.0%	8.0%	8.0%	8.0%	8.0%	8.0%

Source: Capgemini Analysis, 2013; Basel III Phase-In Arrangements, BIS, 2013

3 Tier 2 capital, or supplementary capital, comprises undisclosed reserves, revaluation reserves, general provisions, hybrid instruments and subordinated term debt

Basel III's focus is on capital and funding, and specifies new capital target ratios for banks to comply:

- A common equity (or core equity) Tier 1 requirement of at least 4.5% of risk-weighted assets (RWA)
- A Tier 1 capital of at least 6.0% of RWA
- A Total Capital (Tier 1 + Tier 2) of at least 8% of RWA

In response to the Basel III regulations, banks are already building their capital and funding stocks along with reducing risk off their books in several ways, such as disposition of non-core assets. Due to the ongoing Eurozone crisis and difficulty in enhancing their capital, European banks are lagging behind other regions in terms of enhancing their Tier 1 capital ratios.

The banking sector continues to face key challenges that may have an impact on the financial performance of the banking industry, such as:

- Evolving customer demands and the need for developing new products and services to cater to new customer segments
- Increasing cost of operations due to heightened regulatory and compliance pressure
- Changing customer channel preferences with increasing adoption of mobile and social media
- Rising competition from non-banks (such as retailers and telecom firms)

3. Emerging Technology Trends in Banking

Technology is critical in improving efficiencies, enhancing the customer experience, and achieving regulatory compliance. IT spending by the banking sector is expected to grow by 3.4% in 2013 to reach $179.2 billion and touch $192 billion by 2015. The majority of this growth is expected to come from the Asia-Pacific region, where spending by banks is expected to grow at 5.8% in 2013 to reach $62.8 billion.[4]

The retail banking sector dominates IT spending, which is expected to grow by 4.1% in 2013 to reach $96.1 billion and touch $104.5 billion by 2015. Wholesale/corporate banking is the second most important segment, where IT spending is expected to grow by 3.2% in 2013 to reach $48.2 billion and touch $51.4 billion by 2015. In corporate banking spending, North America is expected to register the highest growth rate of 4.7% in 2013.[5]

The following key industry trends are expected to drive increased investments in technology:

- Banks are enhancing their big data technology capability to successfully leverage their huge database of customer data
- Banks are increasingly investing into analytics to understand customers' needs, improve risk management and compliance, and boost efficiency
- Banks are likely to increase technology investments into digital channels (e.g., Internet, mobile, tablet, and social media) and push toward digital convergence
- Banks are looking to provide better services and products in an increasingly competitive environment and reduce their total cost of ownership by rationalization of the legacy landscape, with a result in core banking transformation gaining pace

Trends in the Global Banking Industry is an annual publication from Capgemini Financial Services that explores global and regional trends for banks.

Trends in the Global Banking Industry 2012

Trends in the Global Banking Industry

4 Celent report on "IT Spending in Banking : A Global Perspective", Jan 2013

5 Ibid

4. Trend 1: Enhance Big Data Capability to Enhance Customer Centricity

Big data analytics is applied in real-time marketing, risk management, and understanding customer needs and behavior.

4.1. Background and Key Drivers

Banks today are realizing the huge potential big data[6] provides in delivering customer value, improving profitability, and managing risks better. Banks and financial services firms have been handling and interpreting customer data for decades but big data provides a game- changing opportunity for banks. The large piles of unstructured data that banks have today provide significant potential in analyzing customer spending patterns, supporting revenue growth, reducing risks, and complying with evolving regulations.

Structured data gleaned from transactional products such as payments, cash management services, trade and supply chain services, and payables/receivables data often sits untouched in banks' data ware-housing applications. With cutting-edge data mining and predictive analytical tools, banks can mine this huge pile of internal data to gain insights and detect patterns in their customers' behavior.

4.2. Analysis

A large number of techniques and systems have been developed to aggregate, structure, and analyze big data. The major challenge that banks face today is the speed at which customer transaction data is increasing every year. In order to analyze this increasing volume of customer data, banks need to invest into big data technologies that can analyze large datasets in real time and customer analytics that can provide real time insights into customer behavior.

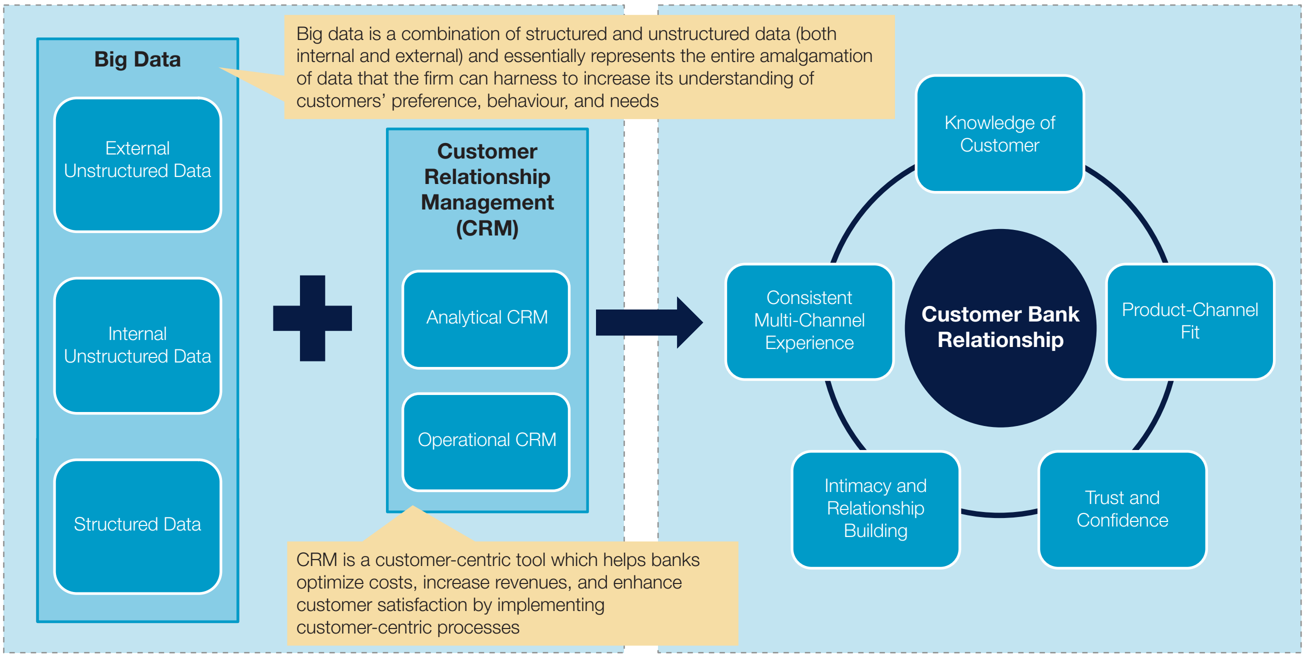
Big data is a combination of both structured and unstructured data where unstructured data can be both external (such as data coming from Internet usage, social media usage) or internal (such as ATM logs, customer-care call logs). Analytical customer relationship management (CRM) leverages big data to improve the core areas of customer-centricity—such as knowledge of the customer, product-channel fit, trust and confidence, customer intimacy, and consistent multi-channel experience. However, there are technological challenges in terms of data capture, data cleaning, and aggregating data to get customer insights.

4.3. Implications

Going forward, as banks realize the importance of big data and as technologies continue to develop and mature to enhance big data capabilities, banks will be able to leverage big data to enhance risk-based pricing, prevent frauds in real-time, analyze customer behavior, and implement real-time marketing targeted to their customers.

6 Big data refers to large data sets of both structured and unstructured data that are difficult to process using traditional database management tools and therefore require new platforms to handle such large volumes, velocity, and variety of data

Exhibit 4: Big Data Technology for Enhancing Customer Centricity in Banking



Source: Capgemini Analysis, 2013; World Retail Banking Report 2013, Capgemini

Specifically, banks will look to enhance their big data capabilities in the following areas:

- **Financial Reporting:** Banks can improve financial reporting and regulatory compliance through better quantification of risk.
- **Customer Analytics:** By leveraging customer data (i.e., customer's channel interaction data and demographic profile), banks can improve CRM as well as marketing and sales activities.
- **Predictive Analytics:** Banks can predict the needs of the customer by looking at past behavior and emerging lifestyle needs and thereby develop products better targeted to customer needs.
- **Fraud Analytics:** Helps to detect cases of fraud or look for patterns that help to predict fraud and thereby prevent fraudulent activities from taking place.
- **Pricing:** Big data analytics helps to improve the pricing of products and services based upon customer demand and customer satisfaction. Pricing of the product also improves, as it can be based upon a better quantification and understanding of the customer's credit default risk.

5. Trend 2: Build Capabilities in Customer Analytics

Business intelligence is relatively static, as it focuses on past data—but predictive analytics is dynamic and forward looking.

5.1. Background and Key Drivers

As the usage of digital channels grows, customers demand more convenience and self-service from their banks. At the same time, the direct interaction between a banker and a customer has almost disappeared. This has prompted banks to improve customer centricity by investing into marketing and analytic platforms.

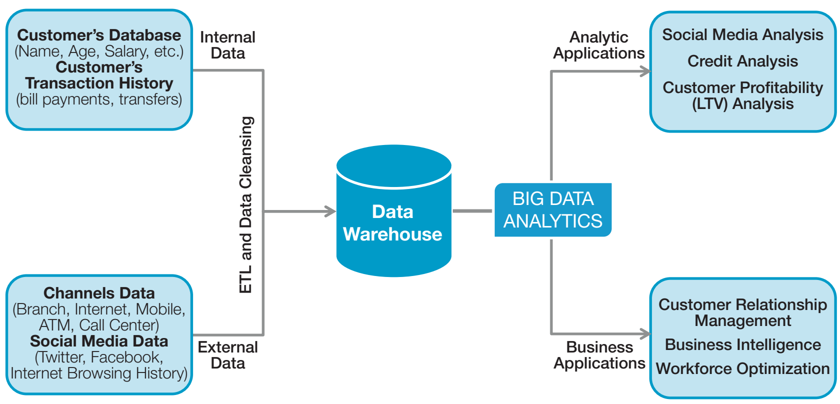
The technology for customer analytics is also advancing in terms of processing, memory, and database design, and now there are a variety of specialized customer analytics solutions available on the market. Banks are now using business intelligence and predictive analytics to increase cross-selling opportunities, advisory activities, and enhancing customer service.

5.2. Analysis

The implementation of data analytics requires changes in database and architecture design to facilitate data retrieval and analysis. In addition to technology considerations, changes are also required in the cultural, organizational, and procedural aspects with active participation of all key stakeholders.

From a cost perspective, increasing availability of cloud-based solutions has enabled financial institutions to realize benefits from analytics with minimal capital investments and IT expenses. There are various specialized analytical tools and advanced vendor solutions that are now available in this space, such as Angoss, IBM, and SAP HANA.

Exhibit 5: Technology for Implementing Analytics in Banking

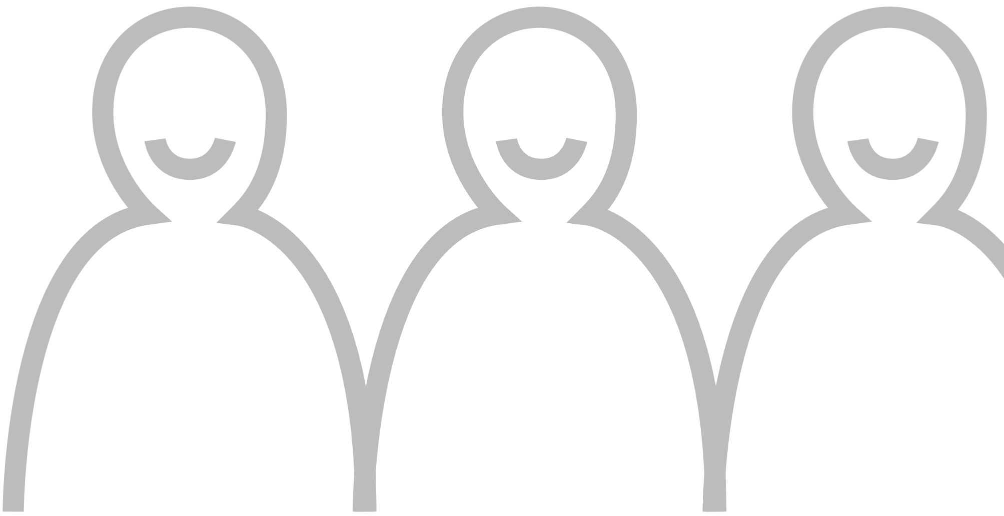


Source: Capgemini Analysis, 2013; "Customer Analytics in Retail Banking: Why Here Why Now", Celent, May 2013

4.3. Implications

Predictive analytics extracts information from data to predict trends and behavior patterns. It is applied in the following areas:

- **Customer Insight:** Analytical applications provide insight into the customer, for instance credit analysis, sentiment analysis and social media analysis. Analytics leverage data to understand customer lifestyle needs and customer behavior, so as to better target customers by offering them appropriate products through the right channel at the right time.
- **Customer Service:** Analytics is used to improve customer interactions by delivering personalized, practical interactions and services to customers. Virtual agents also incorporate analytics for predictive natural language to respond to customer queries. Analytics help to improve contact center performance, improve decision making, and problem-resolution methodologies.
- **Channel Effectiveness:** By leveraging customer-channel-interaction data, analytics can help to enhance and optimize the performance of various channels at interaction points to achieve a consistent multi-channel experience and product-channel fit. Channel analytics is applied in loyalty management, analysis of sales/channel performance, and in achieving product-channel fit.
- **Risk management:** Predictive analytics is applied in fraud prevention and in predicting the likelihood of default.
- **Marketing:** Predictive analytics help to increase the efficiency and effectiveness of sales and marketing in financial services.
- **Sales:** By leveraging customer data, analytics can help generate sales opportunities, build leads and contacts, and enhance sales effectiveness.



6. Trend 3: Transform Digital Channels through Digital Convergence

6.1. Background and Key Drivers

There is an increasing range of devices (tablets, smartphones, and computers) and operating systems consumers can select to do their banking. The rate of adoption of online and mobile banking is rising across all regions. The growth of online and mobile channels has led to new interfaces between different channels and banks today face a challenge to upgrade their existing systems to achieve digital convergence and seamless integration across all channels.

Digital channel convergence will facilitate cross-channel selling and enhance a customer's overall banking experience.

In order to improve customer experience, banks are focusing on achieving convergence in the banking services offered through both online and offline channels and consequently banks are upgrading their core banking platforms in order to provide an enhanced banking experience for both retail and corporate customers.

6.2. Analysis

Banks should have a multi-channel strategy that provides a roadmap for achieving digital channel convergence along with a platform for achieving seamless multi-channel integration. In today's context of multi-channel banking, a typical sales journey may span across multiple channels. Email and mobile are the most common channels banks use for sending information about new product offerings to their customers, while the Internet channel is being commonly used by customers to initiate the purchase for new product offerings. But such cross-channel interaction often results in a broken customer experience and this may cause customer dissatisfaction with a bank.

As a result, smoothly managing the transition between online and offline channels becomes critical in order to enhance a customer's overall banking experience. The online web page should provide a link for customer chat with a service representative, or should provide for a contact form that the customer can fill in to get further information or a personal visit from a sales agent. If the customer initiates a product application form online, the details should be saved, and accessible and downloadable by the sales agent sitting in the branch to process the form when the customer walks into the bank. Lately, social media is also being used to both promote new product offerings as well as receive customer feedback on new products and banking service.

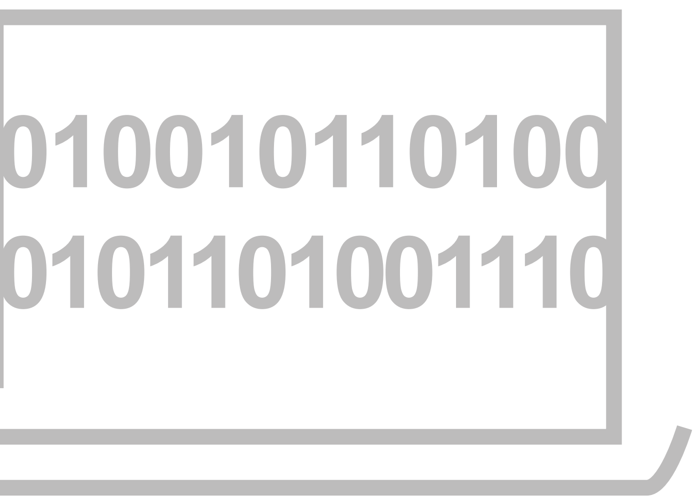
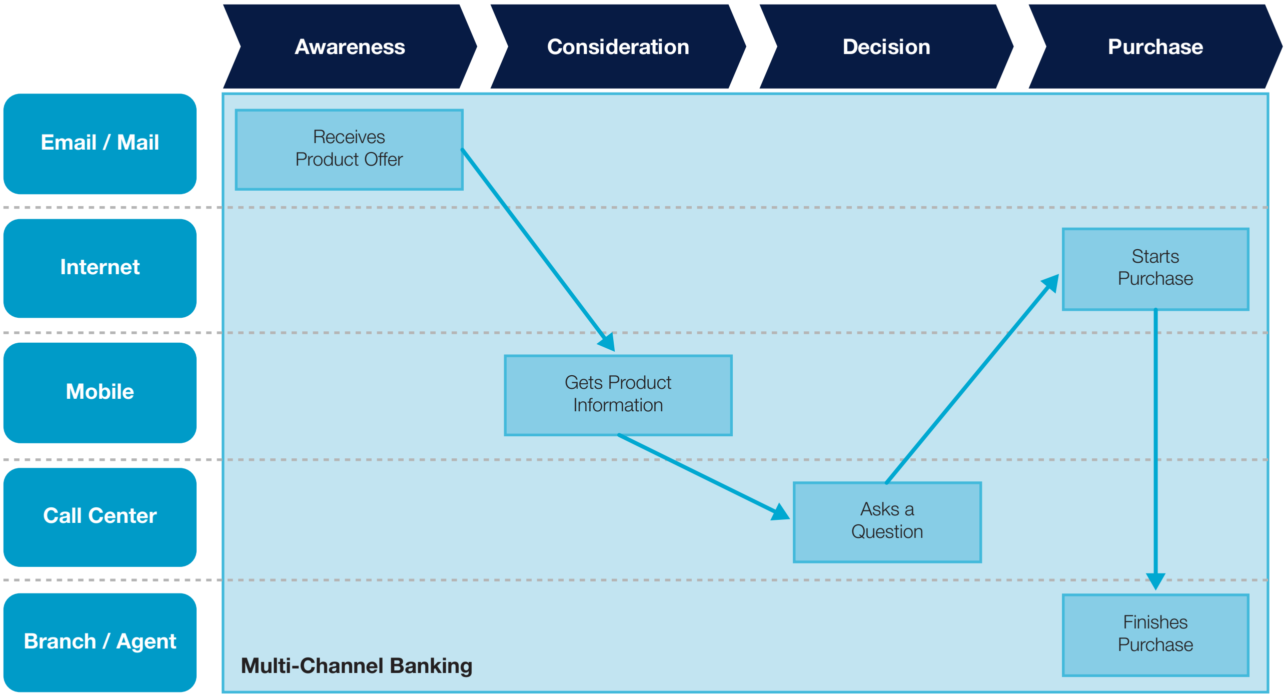


Exhibit 6: Cross-Channel Customer Experience



Source: "Trends 2013: Five Trends Shaping the Next Generation of North American Digital Banking", Forrester Research, Inc., May 2013

6.3. Implications

There are certain technology considerations to address in order to enhance cross-channel experience, as listed below:

- **Open Platform:** Open platform helps digital banking teams innovate faster and differentiate by more easily incorporating solutions by third-party providers or a bank's internal developers via application programming interfaces.
- **Cross-Channel Interaction:** Building a cross-channel experience allows customers to switch channels anytime during their interaction with the bank. For instance, when submitting an application via a mobile app, mobile users can transition to the online or online users can switch to their mobile device to use the app or make a phone call to talk to a bank representative.
- **Virtual Assistance/ Mobile Apps:** Virtual personal assistants help to bring the simplicity and reassurance of in-branch banking to the digital world by using conversational natural language understanding, reasoning, and an in-depth knowledge of banking.
- **Multi-Channel Platform:** This forward-thinking approach delivers an enhanced customer experience and no loss of a sale when the customer tries to switch channels. The key to a consistent cross-channel experience lies in building channel capability on a multi-channel platform.

7. Trend 4: Focus on Core Banking Transformation to Enhance Competitiveness

A flexible core banking system is essential to build a dynamic business-operation model and achieve enhanced competitiveness.

7.1. Background and Key Drivers

Due to sluggish growth and uncertain markets, banks are looking to cut their operating costs in order to increase their profitability. New regulations and liquidity tightening undertaken by some of the leading banks has led to an increase in the cost of funds forcing banks to make efforts to reign in their operating costs. Apart from financial drivers, core banking system transformation is also being driven due to the demands from IT globalization, increasing competition, and industry consolidation.

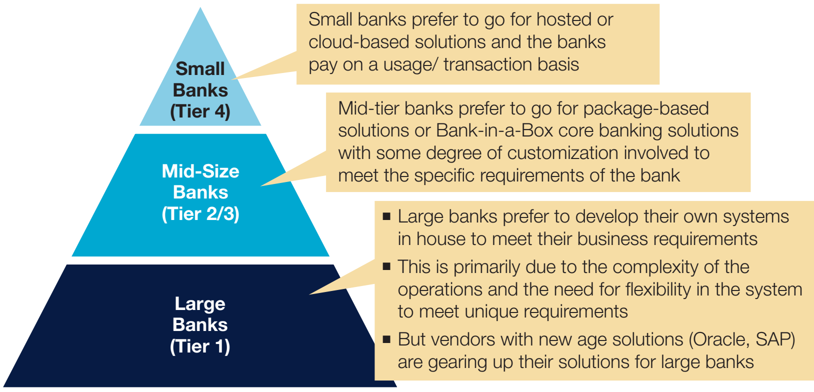
Flexible core banking systems are an essential foundation for realizing the strategies to increase deposits, improve loan origination and servicing, offer innovative products quickly and assess credit risk appropriately. As a result, banks are putting a renewed focus on core banking transformation in order to materialize business benefits and improve their competitiveness.

7.2. Analysis

The process of core banking transformation starts with developing a target business and operating model and then building a case for change. It is then followed by package selection and selecting the IT vendor for core banking implementation.

Core banking transformation strategy depends upon the size of the bank and the complexity of operations and business transformation. For large Tier 1 banks, due to the intricacies of their IT systems, it is preferable for them to develop their own core banking systems. But vendors, such as Oracle and SAP are gearing up to develop core banking solutions for large banks. For mid-size Tier 1 banks, there is a large number of core banking packages available in the market (such as Temenos, TCS-BaNCs, and Finacle) and bank-in-a-box solutions that can be customized to meet specific requirements of the bank. For Tier 3 and Tier 4 banks, there are cloud-based hosting solutions that are both economical and easy to deploy.

Exhibit 7: Core Banking Transformation Strategy



Source: Capgemini Analysis, 2013; "Retail Banking Core Platform Transformation Strategies", Ovum, May 2011

7.3. Implications

Core banking transformation is a complex and expensive undertaking and the following considerations must be kept in mind:

- **Pay-Off Period and Return on Investment:** The pay-off period for core banking transformation usually spans from three to five years and the ROI depends on both direct and indirect benefits of core banking transformation. It is therefore important to assess both quantitative and qualitative benefits of transformation. The qualitative benefits include improved customer service, employee effectiveness and efficiency gains, process improvements, enhanced business growth, and faster time-to-market. The quantitative costs include package licensing fees, implementation costs, and annual maintenance costs.
- **Managing Stakeholders:** Managing the transformation is equally challenging and involves detailed planning and managing expectations of all stakeholders. Strong leadership support and a capable change management team are critical for the success of core banking transformation in conjunction with effective communication and active management of all stakeholders with well-defined roles and responsibilities.
- **Managing Vendor and System Integrator:** Transformation of core banking systems takes years and therefore the long-term viability of the vendor assumes critical importance. Banks must assess vendor's capability to continuously enrich their core banking solutions to meet emerging banking requirements. They should also assess the past record of the system integrator in successfully implementing core banking transformation projects and the maturity of its tools and methodologies.

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