KPMG
cutting through complexity™

Creating a new mould for banking

Evolving business models
September 2010

Financial Services

Contents

Foreword 01

Executive summary 02

01: The financial crisis and its impact 04
- Impacts
- Reactions
- The regulatory burden
- Deleveraging – 'Too big to fail?'
- Improving capital and liquidity
- Trust and confidence
- Uncertainty continues…

02: New business models for the new environment 08
- Responding to regulation
- Liquidity and capital
- Costs and profitability
- A focus on core business?
- Organic growth and acquisitions
- New products and geographic expansion
- A renewed focus on the customer
- On the other hand...

03: New operating models to support new priorities 18
- Improving IT
- Improving risk management and governance processes
- Simplifying management structures
- Off-shoring
- Constraints in the quality and skill-set of employees

04: New models, new landscape 24
- Incumbents better positioned than new entrants
- Major banks will do better than mid- and smaller tier banks
- The renaissance of monetary zones
- Adaptability; long-term strategy
- Government ownership; conflicting priorities

05: How to respond? 28

Acknowledgements 33

About this Report

KPMG International and KPMG member firms interviewed senior representatives of major banks, industry regulators and financial technology companies around the world to understand how banks' business and operating models are evolving. The 25 in-depth interviews carried out in 11 countries yielded a wide range of views on the state of the banking market today, how strategic priorities are changing and what the banking landscape will look like several years down the road.

Editorial contributors

Ricardo Anhesini Souza
Regional Coordinating Partner, Financial Services, Latin America, KPMG in Brazil

Andrew Dickinson
Head of Banking, Asia Pacific
KPMG in Australia

Mitchell Siegel
Principal
KPMG in the US

© 2010 KPMG International. KPMG International is a Swiss cooperative. Member firms of the KPMG network of independent firms are affiliated with KPMG International. KPMG International provides no client services. No member firm has any authority to obligate or bind KPMG International or any other member firm vis-à-vis third parties, nor does KPMG International have any such authority to obligate or bind any member firm. All rights reserved.

Foreword

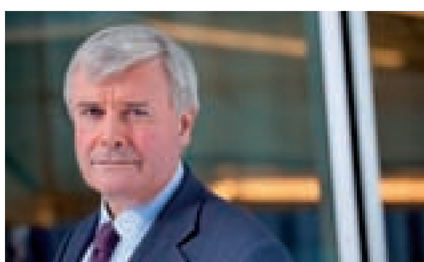
The financial crisis and its aftermath have administered a profound shock to the banking industry. Old certainties have been destroyed, old assumptions shown to have been fatally flawed. Many banks have not survived; some have survived only through government intervention of one kind or another.

It has taken – and is taking – banks some time to work out how to respond to the new environment. For many, survival was the only immediate priority. Now, the task is to review corporate strategy, business models and operating models, to optimize them in light of new constraints. In this context, the results of our survey, and the conclusions we draw from them, provide an important insight into what is happening in the industry now, and how banks' priorities are changing.

A couple of key contrasts emerge. One is that banks in the developed world have been hit hardest by the crisis and are having to undertake more fundamental reconsideration of their business models for the future. Banks in Latin America, Africa and Asia, on the other hand, are refining existing strategy to reflect the new external situation. The second contrast is that, as might be expected, those banks which have survived only through the injection of government support or outright nationalization have very different priorities from those which have remained independent. The challenge to their business models has by definition been greater. But they are also having to respond to complex political pressures. All parties hope to see an orderly return of these institutions to the private sector. But the process of achieving this is exposing severe contradictions in banks' objectives and behavior.

Traumatic though the crisis was, it did not occur in a vacuum. Banks are constantly reviewing and revising their strategy in light of new market conditions, new competition, changing customer expectations and the evolution of technology. When the crisis hit, they were at different stages in this process, and often pursuing different strategic directions. Some may have recently completed major acquisitions. Others may have been pursuing aggressive cost reduction and rationalization. Any understanding of how banks are responding to the crisis has to take into account where they have come from as well as the direction they are now pursuing.

Creating a new mould for banking continues to challenge the industry, in this atmosphere of constraint and uncertainty. Banks have many decisions to make right now, but as usual only hindsight will enable mature judgement.



David Sayer
Global Head of Retail Banking
KPMG in the UK

© 2010 KPMG International. KPMG International is a Swiss cooperative. Member firms of the KPMG network of independent firms are affiliated with KPMG International. KPMG International provides no client services. No member firm has any authority to obligate or bind KPMG International or any other member firm vis-à-vis third parties, nor does KPMG International have any such authority to obligate or bind any member firm. All rights reserved.

Executive Summary

The worst of the financial crisis may possibly be behind us. The most disastrous potential economic impacts seem to have been averted by unprecedented government support and international intervention. But the full extent of the consequences for the banking sector is still emerging. Banks face an entirely new landscape, and are struggling to develop business models which reflect radically different external constraints and which can restore a measure of stability and growth to their different operations.

In our extensive series of interviews with senior banking executives across the globe, regulation – of course – was a dominant theme. So too was the impact of a continuing dramatic shortage of capital and liquidity. In the developed economies of Europe and the US, particularly, there was a real sense of uncertainty and apprehension over what the future will bring.

Retail and commercial banks are having to develop new business models which respond to this environment. For many, this involves slimming down the balance sheet, deleveraging and withdrawal from non-core operations. Nevertheless, a return to growth and profitability has to be a strategic priority. This is leading to a renewed concentration

Figure 1: The new agenda

Executive agenda 2007 (pre-crisis)	Executive agenda 2010 / 2011
Revenue growth	Optimizing balance sheet under capital and liquidity constraints
Maximizing shareholder value	Customer focus
Asset growth	Revenue replacement
Mergers and acquisitions	Comprehensive risk management
Product push	Comply with regulation
Capital and liquidity management	Optimizing stakeholder value

Source: KPMG International, August 2010.

*Not in order of priority

© 2010 KPMG International. KPMG International is a Swiss cooperative. Member firms of the KPMG network of independent firms are affiliated with KPMG International. KPMG International provides no client services. No member firm has any authority to obligate or bind KPMG International or any other member firm vis-à-vis third parties, nor does KPMG International have any such authority to obligate or bind any member firm. All rights reserved.

"The key constraint on us is probably just how much is on the agenda right now and how much there is to do. It's not just the carving out and divesting, it's also the integration. I always say we've got three things to do, we've got business as usual, we've got integration and we've got building the best bank."

EMA respondent

on improving capital and liquidity, a determined focus on the customer to restore trust and confidence, and the development of improved operational models which can both enhance marginal profitability and underpin new growth initiatives.

So banking executives are addressing a markedly different agenda from that before the crisis. As Figure 1 shows, three years ago their priorities were increasing revenues and enhancing shareholder value through product innovation and market penetration, boosted by mergers and acquisitions. Yet now the focus is squarely on balance sheet management, risk management and new regulation.

The crisis didn't hit everybody equally. In some geographic regions, the impact was comparatively slight, and a number of banks are continuing to pursue something like the earlier agenda: the detailed responses to our survey reveal their different priorities. But all banks are having to deal with the fallout in terms of capital constraints and new regulation. Uncertainty over the course of global economic recovery makes the challenge of developing robust new business models much greater.

© 2010 KPMG International. KPMG International is a Swiss cooperative. Member firms of the KPMG network of independent firms are affiliated with KPMG International. KPMG International provides no client services. No member firm has any authority to obligate or bind KPMG International or any other member firm vis-à-vis third parties, nor does KPMG International have any such authority to obligate or bind any member firm. All rights reserved.

01
The financial crisis and its impact

" Regulatory pressures and changes… will continue to fundamentally change the business environment and we have to respond in kind."
USA respondent

© 2010 KPMG International. KPMG International is a Swiss cooperative. Member firms of the KPMG network of independent firms are affiliated with KPMG International. KPMG International provides no client services. No member firm has any authority to obligate or bind KPMG International or any other member firm vis-à-vis third parties, nor does KPMG International have any such authority to obligate or bind any member firm. All rights reserved.

The prime causes of the crisis which hit the global economy in 2007 will doubtless be debated for many years to come. For banks, there are a number of features which had a profound impact.

Impacts

The first was the almost total paralysis inflicted on wholesale funding markets. Virtually overnight the bulk of funding, which many banks relied on both as a long-term strategy and for day-to-day liquidity, ceased to be available. Despite a measure of stability returning to the system, and governments pumping in unprecedented amounts of financial stimulus, credit markets and inter-bank lending remain deeply constrained. In addition, the securitization market has still not re-opened to any significant degree.

This seizing up of credit reflected a traumatic reassessment of risk in the system. The prevailing model assumed that if risk could be sliced, packaged and distributed widely through financial markets then it could be well-understood and managed; safe assets would be just that — safe. Instead, there were ultimately disastrous consequences: the quantum of risk became impossible to estimate, and its eventual ownership became obscure. When no-one could judge which institutions were holding potentially dangerous amounts of risk, the confidence necessary to support financial transactions evaporated. We learned once again that the ultimate foundation of the international banking system is confidence.

Third, the financial crisis began to spill over into the real economy. In the initial phase, only those customers with deposits in failing institutions experienced direct pain. But as the financial markets began shutting down, asset prices were hit, consumer and business credit was withdrawn, jobs began to be lost and recession took hold. As a result, banks took the blame from all sides. In many economies, trust and confidence in banks was severely damaged, and has still to recover.

Reactions

Once the immediate task of preventing complete economic disaster was over, governments, officials and regulators turned their attention to these fundamental issues of credit, risk and confidence. Banks were both contributors to the crisis, and also significantly affected by it. It is inevitable that its aftermath is having a severe impact on many banks' business models, especially in those institutions based in Europe and the US, and that many are finding it hard to develop a sustainable response. Although a large number of banks, most notably those outside Europe and the US, were not *directly* affected *initially*, they were *indirectly* impacted *eventually* by the knock-on effects in the international financial markets and by the response of both governments and international and national regulators. Some banks, particularly those in the Asia Pacific region, with simpler financial structures, came through the crisis in relatively good shape, in part because they did not have the highly complex structures of larger international banks.

© 2010 KPMG International. KPMG International is a Swiss cooperative. Member firms of the KPMG network of independent firms are affiliated with KPMG International. KPMG International provides no client services. No member firm has any authority to obligate or bind KPMG International or any other member firm vis-à-vis third parties, nor does KPMG International have any such authority to obligate or bind any member firm. All rights reserved.

These processes still have some way to go. Recent US legislation (Wall Street Reform and Consumer Protection Act or the 'Dodd-Frank' Act) envisages a raft of new regulations, whose precise impact will not be clear for some months. The G20 summits are progressively redrawing the boundaries of banking practice. In a number of jurisdictions, reviews are under way which could result in the forcible break-up of banking institutions: in the UK, for example, the new coalition government has set up an Independent Banking Commission which will, among other things, consider separating retail from investment banking while restricting the activities of investment banks. Government shareholdings in rescued banks will eventually have to be unwound.

All of these factors create uncertainty. But they are also having a major impact on the way banks are re-evaluating their business models.

The regulatory burden

The burden of regulatory compliance is changing the shape of the banking market. Regulators continue to become more challenging, requiring compliance in shorter timeframes. "Regulators are more visible and more demanding," said one survey respondent. "They want to see reports and compliance with ratios. They are also assessing 'soft' factors such as the quality of management and controls, which will have major consequences for behavior and activities." Bankers fear there will be many negative unintended consequences of the tightening of the regulatory screw, especially in the areas of capital, liquidity and consumer protection. "Politicians do not realize that changes in these areas will affect profitability, will reduce bank lending to the economy and put pressure on economic growth," said a second respondent.

" New liquidity rules are very inflexible. They require a lot of liquidity set up in government bonds, and that is going to increase the cost of doing business. Everything being equal it means less profitability for the sector."

EMA respondent

Deleveraging – 'Too big to fail?'

With the number of banks receiving state aid, particularly in the US and Europe, the need to reduce the size of the balance sheet is also having a major impact on the shape of the market. Following the government bail outs, many countries are now requiring banks to implement share buy-back plans to return them fully to the private sector, and forcing them to sell parts of their business to reduce their size and the risks they pose to the economy if they fail. ING, for example, has been asked to sell its global insurance operations, its investment management business and its US online bank, though it is appealing against the extent of the EU restructuring order .[1] Meanwhile RBS has sold many of its Asian assets to ANZ and Standard Chartered and is required to sell its insurance division as well as parts of its UK branch network and other businesses.

Improving capital and liquidity

Basel III, now being fine-tuned in preparation for publication before the end of 2010, will impose strict new capital and liquidity requirements on banks. New capital and liquidity regulations will create a "cost impost" on banks in Europe and Asia Pacific, said one survey respondent. "Banks will have to work out how to reduce costs in other areas to maintain profit, because the cost of capital and liquidity will increase due to the regulatory changes."

1. "ING completes split of some Dutch banking units," Reuters News, September 8, 2010

© 2010 KPMG International. KPMG International is a Swiss cooperative. Member firms of the KPMG network of independent firms are affiliated with KPMG International. KPMG International provides no client services. No member firm has any authority to obligate or bind KPMG International or any other member firm vis-à-vis third parties, nor does KPMG International have any such authority to obligate or bind any member firm. All rights reserved.

"When I came into banking, I asked 'Where is our cash flow?' And everyone laughed at me because of course we're a bank, we don't have cash flow. Recent events have actually demonstrated the importance of it. What we've found is that liquidity is just as important for a bank as it is for non banks"

EMA respondent

But this is not simply a matter of regulation. Many banks are now realizing that capital and liquidity are as important for a sound banking business as they are for other businesses. One respondent commented that, "We've found that liquidity is just as important for a bank as it is for non-banks": banks have learned again that they need to manage cash flow as closely as any other corporate enterprise. Another said that banks' business models had taken much more risk than their capital could bear "and therefore those business models should, from now on, require more capital than before."

As many international banks recognize the need to diversify their funding profiles and make them more sustainable, against the backdrop of structural deposit deficiencies in many countries, Asia's large savings pool provides access to excess deposits.

Before the crisis, one of the key tasks of successful banking management was optimizing shareholder value within capital constraints. Since the crisis, the task has become much more complex. Not only are there continuing capital constraints, liquidity constraints impose equally severe requirements. And the shareholder family now includes major new bondholders and stakeholders who have additional needs to satisfy.

Trust and confidence

Banks' reputations are arguably at their lowest ebb since the 1930s, and recovery is happening only slowly. "The reputation of banks has fallen steadily through the crisis and continues to fall," said one respondent. "We expect a long process of rebuilding relationships and trust with customers. It will be a major focus. It will take four to five years to rebuild. The average [customer] doesn't take much prodding to decide they don't like their banks."

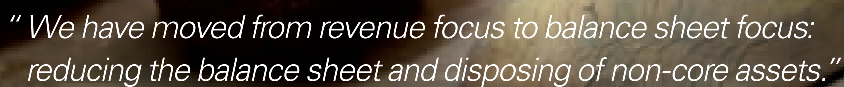
On this note, optimizing stakeholder value is now an important focus for many banks. Supporting this view, one survey respondent highlighted sustainable banking as a key to rebuilding confidence. "An excellent bank does not work exclusively to maximize profit; we are a responsible bank," he said. "Our goal is to serve the public. We also pay a lot of attention to environmental protection."

Uncertainty continues…

There is still a wave of regulatory change to come. Capital and liquidity remain tight and are likely to continue so. Fears exist over sovereign debt, the strength of economic recovery in Europe and the US, and the ability of banks to ride out the worst case scenarios. Banks are having to review their strategies and business models against this uncertain background.

© 2010 KPMG International. KPMG International is a Swiss cooperative. Member firms of the KPMG network of independent firms are affiliated with KPMG International. KPMG International provides no client services. No member firm has any authority to obligate or bind KPMG International or any other member firm vis-à-vis third parties, nor does KPMG International have any such authority to obligate or bind any member firm. All rights reserved.

02
New business models for the new environment



" We have moved from revenue focus to balance sheet focus: reducing the balance sheet and disposing of non-core assets."

EMA respondent

© 2010 KPMG International. KPMG International is a Swiss cooperative. Member firms of the KPMG network of independent firms are affiliated with KPMG International. KPMG International provides no client services. No member firm has any authority to obligate or bind KPMG International or any other member firm vis-à-vis third parties, nor does KPMG International have any such authority to obligate or bind any member firm. All rights reserved.

When our respondents were asked to select their strategic priorities for the next three to five years, significant organic growth was the one most frequently cited (see Figure 6). Other high-ranking priorities included acquisitions, better focus on specific customer segments and entry into new geographic markets. Although parts of the banking industry are still apparently bullish about the medium and longer term, business models to pursue these priorities have to be developed within the core constraints of regulation, capital and liquidity management and profitability.

Responding to regulation

The overwhelming theme of this survey was that, with some exceptions, regulatory pressures were the main drivers for banks to change their business models. The need to focus on financial regulation, to work closely with regulators and to be responsive to new regulations and laws – especially in the areas of capital, liquidity and risk management – is now critical. One or two respondents commented that this was not simply a matter of determining and implementing appropriate quantitative ratios: qualitative judgments also need to be reflected somehow.

Nevertheless, many banks emerged from the crisis relatively unscathed. The banks least affected were those outside Europe and the US, though some European banks with large and diversified operations in Latin America and Asia Pacific regions that were not directly hit by the credit crisis, were also affected minimally. Banks there have had to deal with a difficult couple of years economically, but it has not altered the fundamentals, which are rapidly growing domestic economies and customer bases, and the need to improve products and service.

Four banks in our survey said the crisis had had little direct impact on their business models, though they did admit to being affected indirectly. "There has not been much change to the business model, but we are having to adapt to regulatory change and to changes in banking markets and economies," said one. However, Japanese and Chinese banks include some of the biggest financial institutions in the world, and the crisis has had limited impact on them, at least in terms of credit losses to date.

Liquidity and capital

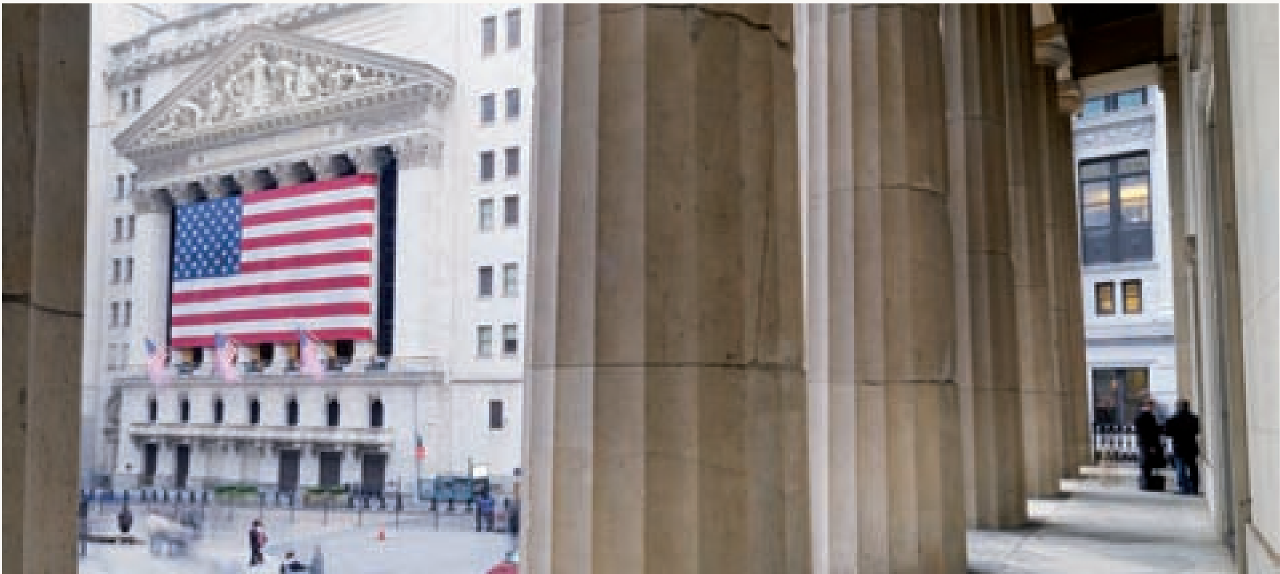
The uncertainty about what levels of liquidity and capital will be required under Basel III is making it harder. The likelihood is that higher liquidity and capital ratios will render some formerly profitable business and operating models uneconomic. US and European banks, especially, are lobbying governments and regulators in the hope that the final rules will on the one hand provide a solid planning basis and, on the other hand, avoid too high ratios which would seriously damage business models or revenue streams. Regulatory pressure imposed by governments was highlighted as a significant driver for changing

© 2010 KPMG International. KPMG International is a Swiss cooperative. Member firms of the KPMG network of independent firms are affiliated with KPMG International. KPMG International provides no client services. No member firm has any authority to obligate or bind KPMG International or any other member firm vis-à-vis third parties, nor does KPMG International have any such authority to obligate or bind any member firm. All rights reserved.

business models, as per Figure 5. Although banks in Asia Pacific and Latin America would also have to comply with the new regulations, funding is not as scarce or as expensive, so the impact there should be less severe.

Just as important as the absolute desired level of capital, is the timing over which capital resources need to be rebuilt. There is a slowly-developing consensus among regulators that this should be pursued over a number of years, so as to avoid major additional shocks which could follow from too rapid a tightening. But politicians, on the other hand, seem to be looking to much more rapid progress towards higher capital levels, which could prove damaging both to financial institutions and the wider economy.

Figure 2: Regional perspectives – US



The US perspective

Returning to profitability is a key objective for US banks.This will require good lending and underwriting standards, regardless of what the product is - whether it is card, consumer, commercial - and ensuring that banks are growing within the acceptable parameters that they set themselves. “We have to learn the lessons of the past couple of years and address our underwriting standards,” said one interviewee.

Improved standards are part of lowering the risk profile, especially where this has become excessive as a result of over-concentration in certain countries products. Banks need to ensure they can offer low-cost products that make sense to consumers with the right level of associated risk. In many cases, US banks already now have better capital planning and liquidity planning models to help them anticipate issues that might arise.

From a revenue perspective, the emphasis has shifted significantly since the crisis. Before, revenue growth was seen as a key component of overall growth and profitability; now, replacing revenue lost as a result of the crisis is a priority in re-establishing stability.

© 2010 KPMG International. KPMG International is a Swiss cooperative. Member firms of the KPMG network of independent firms are affiliated with KPMG International. KPMG International provides no client services. No member firm has any authority to obligate or bind KPMG International or any other member firm vis-à-vis third parties, nor does KPMG International have any such authority to obligate or bind any member firm. All rights reserved.

"We are developing a much more diversified funding mix and we will carry it forward into the future regardless of where the market goes, rather than being three-quarters reliant on a particular funding model."
Asia Pacific respondent

"With new regulations we will see new capital requirements, but there are other limitations that could place constraints on new business and investment," said one respondent. Another interviewee said that the requirement to pay back significant government support will reduce its capital ratios. "We are well capitalized at the moment, but the structure can be improved and will have to be changed due to the timeframe in which we have to pay back the state aid," he said. The timeframe for repayment of state aid needs to be clear, extended and consistent with the recovery of the bank. Another said that banks have been forced "to improve their capital planning and liquidity planning models to help them anticipate future problems they may encounter".

Costs and profitability

Pressure to improve profitability by cost reduction and by growth was a common theme as demonstrated in Figure 5. On the revenue side banks need to find new customers and extract more income from existing customers, increase margins, gain more market share, regain (or at least, maintain) customer trust, and respond to new and innovative market entrants.

On the cost side they need to pare down costs where they can, reduce their risk profiles and improve the quality of loan portfolios. "Costs have to remain under control," said one survey respondent, even though his bank already has a low cost-income ratio. "We are one of the most efficient banks in the world, but we want to stay there for a long time."

Spending more wisely...

Over and above systemic shocks in write off and provisioning levels, significant pressures on margins have resulted in a renewed sense of urgency and commitment to optimize costs. Many banks are finding that having introduced horizontal manufacturing layers across their organizations they can still yield significant cost savings. In many cases it seems that deployment of lean manufacturing had been executed softly, with still more scope to improve.

In search of new ways to save cost, there is also renewed focus on functional outsourcing. This is proving to be quite complex as it requires a thorough assessment of increased level of risk, required management capacity, the possibility of negative impacts on customer service quality and potential loss of core banking expertise.

The final piece in the jigsaw (which has evaded most banks in the good times) is the introduction of effective cost management disciplines, driving transparency into cost behaviors, and enabling both an understanding of how costs will behave in different scenarios and real tracking of cost outcomes against headcount flows and business decisions.

Adrian Harkin
Partner
KPMG in the UK
adrian.harkin@kpmg.co.uk

© 2010 KPMG International. KPMG International is a Swiss cooperative. Member firms of the KPMG network of independent firms are affiliated with KPMG International. KPMG International provides no client services. No member firm has any authority to obligate or bind KPMG International or any other member firm vis-à-vis third parties, nor does KPMG International have any such authority to obligate or bind any member firm. All rights reserved.

Figure 3: Regional perspectives – Asia Pacific

The Asia Pacific perspective

During the crisis some Asia Pacific economies saw significant reductions in GDP late in 2008 and early 2010. This resulted in a 'pressure to lower risk profile' as banks prepared for the anticipated fallout. However, much of the fallout never happened and the region has bounced back strongly from these lows, led by growth in China in particular.

During this time, Western banks have been focused elsewhere, although they are now returning to the region to compensate for lack of growth in their own markets. This has presented growth opportunities for banks in the Asia Pacific region, particularly in serving the needs of the emerging middle classes. The full benefits of this have yet to come through due to margin compression, which may linger as governments try to pay down debt.

Nevertheless, the strong growth prospects in this part of the world stand in contrast to those in north America, Europe and Japan and represent a golden opportunity for Asian banks, provided they develop quickly to capitalize on the opportunity.

As a result, there is now a need for renewed focus on managing not only regular operating costs but also the costs of capital, liquidity and regulation. None of these should be accepted simply as imposed externally. Each of them offers scope for creative and constructive management. Competitive advantage can be gained by managing these costs with the same rigor as more traditional cost and efficiency strategies.

© 2010 KPMG International. KPMG International is a Swiss cooperative. Member firms of the KPMG network of independent firms are affiliated with KPMG International. KPMG International provides no client services. No member firm has any authority to obligate or bind KPMG International or any other member firm vis-à-vis third parties, nor does KPMG International have any such authority to obligate or bind any member firm. All rights reserved.

"In order to raise profitability and increase diversification the bank plans to change its customer mix over time to become more consumer-oriented. Therefore, the bank faces the challenge of developing different channels in order to meet the needs of its heterogeneous customer base."
USA respondent

We asked respondents what they believed would be the most profitable lines of business in the next three to five years, throughout the banking spectrum. Unsurprisingly, the majority identified retail banking. One bank, which currently generates around 38 percent of its revenues from retail and 62 percent from commercial, said it was planning to move towards a 50-50 split because the former is more profitable. "When dealing with consumers, usually any one consumer failure doesn't impact as much as one company failure does," he said, in justifying the move. "You can better estimate losses and behavior. Dealing with consumers you have the law of averages; on the commercial side you don't."

In the US we also found that the SME sector was considered to be an area of future profitability. Interestingly, in Asia Pacific and Europe, private banking/ wealth management were still quite high on the list, followed by corporate and investment banking. One European bank believes that no specific business lines would show higher profitability, but that profit will come more from cutting costs and bringing synergies to the business through outsourcing or using new channels.

A focus on core business?

The crisis severely damaged bank profitability around the world. One respondent estimated that French banks alone lost approximately €30billion in profits, representing two or three years' net earnings. During the crisis banks were almost solely focused on survival, but to rebuild their business many, particularly in the developed economies which were harder hit by the crisis, are going 'back to basics'. This includes, among other things, simplifying products to meet customer needs, reducing costs, restoring profitability and focusing on retail deposits for funding.

While many banks are now enjoying widening asset margins, liability margins remain very constrained. Many banks are responding by concentrating on domestic services and downsizing the business by exiting non-core portfolios such as property development and corporate lending. One respondent said the quality of his bank's loan portfolio was being improved. "We maintain strong credit quality because we are not big enough to sustain big losses. We don't need to take risks and move into parts of the market that are higher risk when we can stay with our core business," he said.

Organic growth and acquisitions

Growing organically remains the most favored, if least spectacular, route to expansion as shown in Figure 6. Acquisitions and mergers grab the headlines, but steady, solid organic growth through balance sheet expansion and branch creation is seen as a less risky path. "Last year we shrank our balance sheet by 17 percent", said one banker. "I think that in the next three to five years there will be 20 percent compound growth in our balance sheet."

© 2010 KPMG International. KPMG International is a Swiss cooperative. Member firms of the KPMG network of independent firms are affiliated with KPMG International. KPMG International provides no client services. No member firm has any authority to obligate or bind KPMG International or any other member firm vis-à-vis third parties, nor does KPMG International have any such authority to obligate or bind any member firm. All rights reserved.

One bank which has only recently entered the market said that coming from a low base provides major opportunities for gain, and that it is likely to expand more quickly than the market average. It does not, therefore, need to entertain the idea of acquisitions. On the other hand, another bank said that while it planned to build its branch network by 500 more branches "in the next couple of years," it would continue working on its post-merger integration efforts, having acquired a major retail bank at the height of the crisis. Furthermore, it would also look at another acquisition "where the price is right and it is complementary to our network."

Many banks are seeking to expand through acquisition in the Asia Pacific region to get exposure to the Asian growth story. Over the past 18 months there has been considerable M&A activity, particularly in South-East Asian countries, like Indonesia, Vietnam and Thailand. In addition, the large state-owned Chinese lenders have announced plans to expand their overseas lending activities, particularly in syndicated loans.

"New liquidity, capital and price constraints are not so much challenges to the operating model, but what we consider when developing the business model."

USA respondent

In the US, the banking sector is entering a new wave of consolidation, especially among medium-sized and smaller banks. The US still has some 8,000 of these institutions, many of which lack the balance sheet strength to prosper in the new environment. A steady stream of failures is feeding regular auctions of insolvent institutions and asset portfolios by the Federal Deposit Insurance Corporation (FDIC), offering opportunities for acquisitions. In principle, this could allow new entrants into the banking sector, and a number of private equity groups have been set up for the purpose. In practice, the FDIC are wary of new entrants, since they generally lack a core base of business, a proven track record in the banking industry, and are vulnerable to significant losses in the early years of incorporation. While acquisitions are likely to accelerate in the US, they are more likely to lead to further consolidation than to a significant number of major new entrants.

New products and geographic expansion

New products and expanding into new geographic markets also rated among the top four strategic priorities (see Figure 6). Moving into emerging markets is seen as worthwhile, not only to tap into existing business opportunities and future potential but also as a way of diversifying income streams and risks. Furthermore, it is not just banks in mature economies doing this; banks in developing countries are setting up operations in other emerging markets. "International expansion is one of the most important strategies of the bank," said one executive from a major developing economy bank. "However, rather than blindly expanding, this strategy will be implemented carefully to ensure that the bank does not expand beyond its competence."

© 2010 KPMG International. KPMG International is a Swiss cooperative. Member firms of the KPMG network of independent firms are affiliated with KPMG International. KPMG International provides no client services. No member firm has any authority to obligate or bind KPMG International or any other member firm vis-à-vis third parties, nor does KPMG International have any such authority to obligate or bind any member firm. All rights reserved.

Figure 4: Regional perspectives – Latin America

The Latin American perspective

Latin American countries have fared better in the global crisis than many more developed economies. Part of this is due to historical factors, but it is also because there is more room for growth in these countries and less exposure to international events. The key priority in this region is to capitalize on opportunities to grow market share. This is in fairly stark contrast to views held elsewhere in the world.

In the main, bankers in developing economies are concentrating on continued growth in domestic markets, increasing profitability and serving their customer base more effectively.

A renewed focus on the customer

Many banks are stressing a new, or renewed, focus on customer service. This was the single most common change to business models cited in our survey; in Latin America and Europe, it was named as the top priority. "We will offer different levels of service and a different proposition to customers, rather than compete just on price," said one banker. "We have segmented customers into four categories: youth, high net-worth, mass affluent and single-product seekers." Many banks are seeking to reposition themselves as more than just suppliers of products and services, instead as providers of 'solutions'. However, they face a challenge in overcoming customers' historic reluctance to pay more for advice and services.

© 2010 KPMG International. KPMG International is a Swiss cooperative. Member firms of the KPMG network of independent firms are affiliated with KPMG International. KPMG International provides no client services. No member firm has any authority to obligate or bind KPMG International or any other member firm vis-à-vis third parties, nor does KPMG International have any such authority to obligate or bind any member firm. All rights reserved.

Online banking will continue to play a key role in banks' becoming more customer-centric. "An increasing number of our clients are asking for enhanced online services and products," said one banker. "The growth rates are not revolutionary, but we need to make evolutionary changes to ensure we keep our customer base stable." By contrast, some banks with an *online banking only* model are considering the possibility of creating a small number of branches in major population centers to provide the human touch and to build a more visible presence, although the cost of bricks-and-mortar remains a major obstacle.

More than one respondent pointed to the growing importance of mobile banking. One commented: "Internet [banking] replaced telephony… Mobile will, in my view, replace internet over time… Mobile will be a big change to our business." While branches will remain important, the future will increasingly be one of 'bricks, clicks and texts'. More than one bank also noted the increased significance of private banking.

This renewed focus on the customer is beginning to have an impact on the management structure and organization of some multinational banks. One European bank told us that they are moving away from management by global business lines to a more regional structure. Global functions, such as risk and compliance, would still be led centrally. But customer-facing operations would be managed closer to individual domestic markets.

A renewed focus on customer protection is being seen in the way regulation of banks' conduct is supplementing prudential regulation. Banks are under pressure to develop simple, clear products which can be easily explained to and understood by customers. While this is in some ways to be applauded, one unintended consequence may be a major constraint on the availability of products which are more complex but appropriate to certain customer groups. Some consumers may no longer be able to buy products which would meet their specific needs, because the banks will deem them too risky to sell in future.

On the other hand…

A number of banks have no plans to change their business models, even if they have been affected by the crisis, because their models have proved to be workable, fit-for-purpose and still relevant. "In some parts of our European operations there will have to be cost cutting, consolidation and restructuring, but they're just adjustments – the core business model will be the same," said one respondent. In some cases this was due to the banks being focused on a part of the economy which was not significantly hit by the crisis. However, as with any fast-changing industry, their business models are still evolving to keep pace with the environment.

© 2010 KPMG International. KPMG International is a Swiss cooperative. Member firms of the KPMG network of independent firms are affiliated with KPMG International. KPMG International provides no client services. No member firm has any authority to obligate or bind KPMG International or any other member firm vis-à-vis third parties, nor does KPMG International have any such authority to obligate or bind any member firm. All rights reserved.

Figure 5: What are the drivers for changing business models?

Issue	USA	Latin America	Asia	EMA	Global
Regulatory pressure to improve capital and liquidity levels					1
Regulatory pressure on legal/ business structure imposed by government					2
Pressure to lower the risk profile of the organization and improve risk management					3
Pressure to achieve cost optimization					3
Opportunity to gain market share					4
Regain customer trust					5
Returning to profitability					6

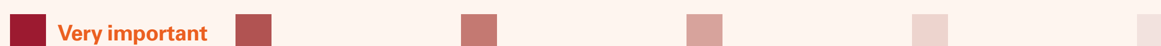
Source: KPMG International, August 2010.

Figure 6: What are banks' strategic priorities?

Issue	USA	Latin America	Asia	EMA	Global
Significant organic growth					1
Entry into or better focus on specific customer segments					2
Entry into new geographic markets					2
Entry into new product areas					3
Acquisitions					4
Business as usual					5
Major divestments in the form of spin-offs or MBOs					6

Source: KPMG International, August 2010.

Key – Responses ranked by importance



© 2010 KPMG International. KPMG International is a Swiss cooperative. Member firms of the KPMG network of independent firms are affiliated with KPMG International. KPMG International provides no client services. No member firm has any authority to obligate or bind KPMG International or any other member firm vis-à-vis third parties, nor does KPMG International have any such authority to obligate or bind any member firm. All rights reserved.

03 New operating models to support new priorities

"There is an increased need for effective governance and decision-making mechanisms, in order to make strategic guidelines really applicable."

EMA respondent

© 2010 KPMG International. KPMG International is a Swiss cooperative. Member firms of the KPMG network of independent firms are affiliated with KPMG International. KPMG International provides no client services. No member firm has any authority to obligate or bind KPMG International or any other member firm vis-à-vis third parties, nor does KPMG International have any such authority to obligate or bind any member firm. All rights reserved.

Banks did not need a financial crisis to focus their attention on improving operating models. The constant struggle for cost reductions, operating efficiencies and – often – better ways of integrating acquisitions, has always driven innovation and change. What the crisis has done is twofold: to accelerate the search for efficiency, and to drive the development of new operating models to meet the demands of the new environment and changed business models. Systems, processes and management structures are all implicated. Behind these, lies the challenge of talent management.

Improving IT

In the banking industry, improving IT processes goes hand-in-hand with overall process efficiency improvement and was the primary area of bank's operating models they would change to adapt to new business models (Figure 7). "All processes are under review, partly on the basis of complaints coming from customer satisfaction surveys," said one respondent. Another said: "We need to make some changes to our IT… There are two aspects; the first one is IT security, and the second one is process support." The difficulty of adapting IT processes is one of the key challenges to implementing change to business models (see Figure 8).

Market and regulatory changes are additional complicating factors. Banks that have recently undergone mergers have particular problems in integrating disparate systems into one "ready-for-the-future" system, as one banker put it. The challenge of adapting IT processes will require further planning and the adoption of a structured view of how IT can more effectively support the business model.

© 2010 KPMG International. KPMG International is a Swiss cooperative. Member firms of the KPMG network of independent firms are affiliated with KPMG International. KPMG International provides no client services. No member firm has any authority to obligate or bind KPMG International or any other member firm vis-à-vis third parties, nor does KPMG International have any such authority to obligate or bind any member firm. All rights reserved.

"Normally, the development of IT systems in banks lags behind the development of the business. To cope with our new goals, such a time-lag in IT system development is not acceptable."

Asia Pacific respondent

Efficient systems

A major trend we are seeing in the post-crisis environment is that many CIOs within the banking sector are focusing on operational performance and improvement. There is less of a focus on major transformational change.

Cost reduction and optimization, and standardization of systems and processes are crucial at this stage of the business lifecycle. Organizations are finding that they must get greater efficiency with less committed operational budgets. We will see a continual trend in technologies such as cloud computing, virtualization and outsourcing/off-shoring especially as organizations continue to reduce costs.

Egidio Zarrella
Partner, Advisory
KPMG in China
edidio.zarrella@kpmg.com.hk

"We have noticed that there is a new trend in risk management which is a movement away from, either solely depending on models or solely relying on experience, towards employing an 'experts + models' method to assess and manage risks."

Asia Pacific respondent

Improving risk management and governance processes

The crisis has focused renewed attention on risk management and governance. Banks in all regions have made substantial progress here in the attempt to satisfy new and impending regulation. The newly-enacted (Dodd-Frank Act) in the US will require renewed effort to ensure compliance. Non-US banks will also have to comply with the new regulations, at least in respect of their US-based businesses, but also to the extent that there are implications for the rest of their global business. "Banks will have to strengthen their global business model and navigate through the global regulatory system," noted one interviewee.

Simplifying management structures

Corporate centers have to be examined constantly to see if there is scope for cutting them down in size with the simplification of the managerial structure being highlighted as a key change to operating models (Figure 7). "The complexity of operations in any sector of the bank is one of the main issues to be solved in the next three years," said one respondent. Another said: "Under a large cost optimization project we are doing we will be more regionalized. Activities need to be decentralized but management and central executives must adopt a 'hands-on' attitude."

© 2010 KPMG International. KPMG International is a Swiss cooperative. Member firms of the KPMG network of independent firms are affiliated with KPMG International. KPMG International provides no client services. No member firm has any authority to obligate or bind KPMG International or any other member firm vis-à-vis third parties, nor does KPMG International have any such authority to obligate or bind any member firm. All rights reserved.

"The benefits of off-shoring are decreasing. There are regions in the US that don't look that unfavorable from a cost basis, compared to India for instance."

USA respondent

Off-shoring

The search for improved efficiency and rationalization of back-office functions is continuing to drive interest in outsourcing and off-shoring by banks in the developed economies. Locations such as the Philippines are establishing reputations for strong and professional performance in servicing banks. However, some respondents expressed caution. It is important that new initiatives do not run counter to a renewed focus on customer service. For example, some banks are now stressing in their marketing that their customer service centers are located on-shore. And one respondent from a US bank commented that the economic advantages of off-shoring seemed to be becoming less compelling. It is likely that further outsourcing and off-shoring will continue, but in a carefully-targeted manner.

On or off?

Labor arbitrage and the ability to serve customers 24/7, while providing substantial cost savings, have been the key drivers for off-shoring banking processes. Following the crisis, we are seeing a growing interest in on-shore outsourcing, which has helped in stabilizing price points. However, this seems to be a fairly short term approach. As the economy recovers, it will become increasingly difficult to sustain this model, due to rising costs. It would lead to a waste of valuable resources that could have been used for innovation and improving liquidity.

Moreover, the availability in off-shore centers of a lower-cost labor pool will reduce as workers move to newer and better opportunities or demand higher wages. Eventually, service providers will be forced to pass on these cost increases to the outsourcing buyer/client, negating the off-shoring/outsourcing advantage altogether.

It is now essential for greater synergy and a sense of partnership between the banks and the off-shore service providers to create new areas of value addition. Both parties must be equally responsible to sustain a successful and profitable relationship with major focus on value creation. Companies in the financial services sector need to move up the value chain and consistently innovate in order to survive. They must transform their outsourcing model to an end-to-end business transformation model in order to achieve immunity from future economic disruptions.

Kumar Parakala
Global Head of Sourcing
KPMG in India
kumar@kpmg.com

"Retail banks are starting to look at global centers of excellence for higher end processes. The margins are higher and it gives access to a larger labour pool which can be part of the global pool."

Shamus Rae
Partner
KPMG in the UK
shamus.rae@kpmg.co.uk

© 2010 KPMG International. KPMG International is a Swiss cooperative. Member firms of the KPMG network of independent firms are affiliated with KPMG International. KPMG International provides no client services. No member firm has any authority to obligate or bind KPMG International or any other member firm vis-à-vis third parties, nor does KPMG International have any such authority to obligate or bind any member firm. All rights reserved.

Figure 7: How will banks change their operating model to adapt to new business models?

Issue	Global
Improved IT processes	1
Simplification of the managerial structure	2
Better customer service	2
Diversification of distribution channels	3

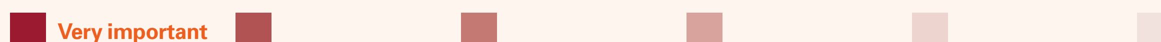
Source: KPMG International, August 2010.

Figure 8: What are the challenges to implementing change?

Issue	USA	Latin America	Asia	EMA	Global
Adapt IT and systems to be fit for the new purpose					1
New liquidity requirements make change in business / operating model uneconomic					2
Constraints in the quality and skill set of employees					3
Capital constraints to achieve the new business / operating model					4

Source: KPMG International, August 2010.

Key – Responses ranked by importance



© 2010 KPMG International. KPMG International is a Swiss cooperative. Member firms of the KPMG network of independent firms are affiliated with KPMG International. KPMG International provides no client services. No member firm has any authority to obligate or bind KPMG International or any other member firm vis-à-vis third parties, nor does KPMG International have any such authority to obligate or bind any member firm. All rights reserved.

"Constraints in the quality and skill set of employees are a daily challenge."

Latin America respondent

Constraints in the quality and skill-set of employees

As financial markets have begun to recover, competition for staff has intensified. The shortage of high-quality recruits is made worse by the fact that banks have become less desirable places to work than they were three years ago because of the reputational damage they have suffered. "There is a war for talent," as one bank bluntly put it. "It is becoming difficult to get out of our schools and universities people with the relevant level of qualifications to become advisers. Banks have lost their good position as a first-choice employer, due to their damaged reputation." "Constraints in the quality and skill-set of employees are a daily challenge," said another.

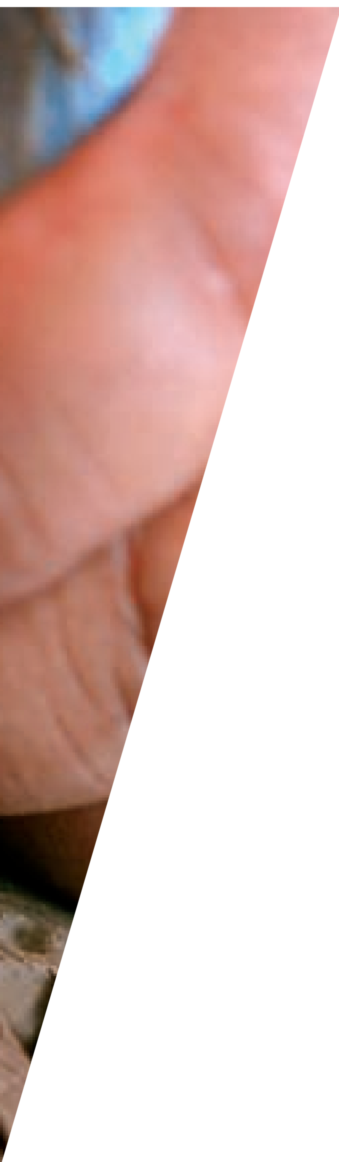
The growing focus on restraining bank remuneration and bonus structures in Western Europe and the US is causing further difficulties. Banks in Asia Pacific which survived the crisis in fairly good shape are now able to hire top-quality traders and investment bankers, especially from Europe, who are attracted by bonus arrangements which are still relatively unconstrained. Despite this, one interviewee said the bank had to ensure it did not pay salaries that were too high. "The cost of employees is more important than the skills they bring, so we have to get the cheaper people and train them in the skills needed for the mass market," he said.

As we have seen, banks in Latin America weren't hit by the crisis as severely as those in other regions; they had less exposure to the risky financial products devised and heavily used in developed countries. As a result, Latin America's banking sector is now recovering better than most and a shortage of adequately skilled staff is one of the key challenges it faces.

© 2010 KPMG International. KPMG International is a Swiss cooperative. Member firms of the KPMG network of independent firms are affiliated with KPMG International. KPMG International provides no client services. No member firm has any authority to obligate or bind KPMG International or any other member firm vis-à-vis third parties, nor does KPMG International have any such authority to obligate or bind any member firm. All rights reserved.

04
New models, new landscape

© 2010 KPMG International. KPMG International is a Swiss cooperative. Member firms of the KPMG network of independent firms are affiliated with KPMG International. KPMG International provides no client services. No member firm has any authority to obligate or bind KPMG International or any other member firm vis-à-vis third parties, nor does KPMG International have any such authority to obligate or bind any member firm. All rights reserved.



The banking sector is entering a period of significant industry restructuring. The first stages have seen the collapse of insolvent institutions and the – temporary – absorption into public ownership of others. The next stages will see divestments and acquisitions, both voluntary and in response to pressure from policymakers. Nationalized institutions will eventually return to the private sector, no doubt in different forms. New entrants are beginning to appear. A wave of consolidation among smaller institutions, especially for instance in the US, is likely. These developments will magnify the impact of new business models and change the landscape of banking.

Incumbents better positioned than new entrants

New entrants to the market could pose a serious competitive threat to traditional, long-established players. New start-up banks are already being set up to buy parts of large banking groups that are being sold to slim down balance sheets or because governments say they must be disposed of to meet strict competition rules. Other newcomers are non-banking organizations – high street or online retailers who want to use their loyal customer base as a launching-pad into retail financial services.

Some of the bankers we interviewed expressed concerns about more competition. One point made, for example, was that if banking regulation gets too tough, financial organizations that do not have banking licenses, and are therefore not subject to the same strict regulations as banks, may be able to poach parts of their business.

However, other interviewees expressed the opinion that new entrants would struggle to make much of an impact. The costs and barriers to entry are too high for established bankers to be truly threatened. The Basel III regulations on capital and liquidity – not to mention the multitude of other regulatory developments – will act as a deterrent and make it harder and more expensive for new entrants to enter the market. Some of the larger banking groups will undoubtedly be partially broken up. But divested operations are likely to be acquired by other large groups, thus increasing their own dominance.

There was a spectrum of opinion on whether banks from major developing countries such as Brazil or China would be seen entering banking in Europe or America. Some believed that the circumstances were quite favorable. Others argued that such moves would represent a diversion of funding and a distraction from the significant opportunities available in their domestic markets.

© 2010 KPMG International. KPMG International is a Swiss cooperative. Member firms of the KPMG network of independent firms are affiliated with KPMG International. KPMG International provides no client services. No member firm has any authority to obligate or bind KPMG International or any other member firm vis-à-vis third parties, nor does KPMG International have any such authority to obligate or bind any member firm. All rights reserved.

"We are going to fight but we must be ready to deal with new competitors. Low-cost companies can earn money in this market."

EMA respondent

So while there will be a number of new banks coming on to the scene, banking globally is likely to become more, rather than less, concentrated in the next two years. The mergers that have happened in Europe and the US are indicative of this trend toward consolidation.

Major banks will do better than mid- and smaller tier banks

The likelihood is that the majors will be the winners, and continue to dominate the mid- and smaller tier of banks. "The majors have a competitive advantage over second-tier banks," noted one respondent. "They are highly rated, big profitable engines, and a lot of business is being driven to them." They are usually highly diversified too, across client types, product areas and geographical regions, which cushions them against sector and regional downturns. Despite the crisis, the universal banking model has shown its resilience.

Banking is a business which returns significant rewards for scale. Large banks have a major cost advantage over smaller competitors. Smaller banks will experience difficulties because of their limited economies of scale. Many will have to stop manufacturing their own products and focus instead on distribution or on providing highly specialized products and services to smaller segments of customers.

It is notable that most of the new entrants to the market are focusing on providing a higher level of service, and on attracting those customer segments which will pay a premium for that. They cannot afford to compete providing a one-size-fits-all service at low cost.

The renaissance of monetary zones

"Tougher competition and regulation will reduce profitability of the bank overall."

Latin America respondent

Continued strains on all the major currencies, coupled with concerns over sovereign debt, are refocusing bankers' attention on the significance of monetary zones for their business models. The US dollar has come under a lot of stress. Confidence in sterling has been damaged by the very high level of government debt and budgetary deficit in the UK. The euro is suffering from internal strains, from the Greek bail-out and from fears of further weakness in Southern European economies. The downward pressure on all three of these major currencies has led to a significant increase in volatility.

These circumstances are beginning to have significant impacts on asset allocation. Bankers are increasingly realizing that it is important to maintain sufficient liquidity in the currencies relevant to their international operations. The value of a significant local retail banking operation is that it generates cash in the appropriate currency. As a consequence, some banks are drawing back from business lines which do not satisfy this criterion. One European bank told us they will no longer be expanding consumer credit operations in markets where they don't have a strong retail banking presence.

© 2010 KPMG International. KPMG International is a Swiss cooperative. Member firms of the KPMG network of independent firms are affiliated with KPMG International. KPMG International provides no client services. No member firm has any authority to obligate or bind KPMG International or any other member firm vis-à-vis third parties, nor does KPMG International have any such authority to obligate or bind any member firm. All rights reserved.

" It's interesting to have new competitors out there… undoubtedly we will be able to learn things from those competitors, we just have to up our game as well."

EMA respondent

Adaptability; long-term strategy

"The winners are always the ones that are best at adapting quickly to change, and the losers those who are slow to adapt," said one respondent. The key is to know where to look for new revenues, how to shave costs where possible, improve profitability and comply with new regulatory demands. Low-cost providers will do well.

At the same time, the strategic outlook has to be long term, which will be difficult to reconcile with the wishes of shareholders, the majority of whom take a short-term view. "To balance the short-term requirements of investors with what you believe is the right long-term answer, and is going to differentiate between winners and losers; if you focus too much on the short term you will make bad decisions that will cost you in the long run," said one interviewee.

Looking back on the crisis, those banks which survived best were those which resisted intense pressure from shareholders and the investor community to adopt more aggressive strategies in the pursuit of higher returns. But it is difficult to hold out against the majority view, even if it turns out to have been right to do so.

Government ownership; conflicting priorities

Until they can eventually be returned to the private sector, those banks which have had to be recapitalized or nationalized by government will continue to cause major distortions in the market. Governments are already beginning to realize that actions which seemed simple and essential at the time are carrying unintended consequences. Politicians are relying on retail banks to resume lending to customers and businesses to underpin what remains a fragile recovery. At the same time, pressure from governments but also from shareholders is driving these banks to shrink their balance sheets, increase fees and charges to rebuild profits and adopt highly defensive risk-averse strategies.

The clamor for banks to play a responsible role in supporting recovery is getting louder: and louder still as governments realize they have no further capacity for fiscal loosening or monetary expansion. The banks are advertising that they are ready to fund any and all 'bankable' prospects. But at the same time, their need to rebuild balance sheets means they are having to call in loans or impose higher rates across much of the Western economy. On the borrowers' side, many consumers and businesses are choosing to pay down debt and reduce future borrowing while significant uncertainty continues. These major distortions to the market are still with us, and create a challenging and uncertain environment for those independent banks developing and pursuing new business models.

© 2010 KPMG International. KPMG International is a Swiss cooperative. Member firms of the KPMG network of independent firms are affiliated with KPMG International. KPMG International provides no client services. No member firm has any authority to obligate or bind KPMG International or any other member firm vis-à-vis third parties, nor does KPMG International have any such authority to obligate or bind any member firm. All rights reserved.

05
How to respond?

© 2010 KPMG International. KPMG International is a Swiss cooperative. Member firms of the KPMG network of independent firms are affiliated with KPMG International. KPMG International provides no client services. No member firm has any authority to obligate or bind KPMG International or any other member firm vis-à-vis third parties, nor does KPMG International have any such authority to obligate or bind any member firm. All rights reserved.

Common constraints, different strategies

The results of our survey reveal some common themes in the external pressures being imposed on banks' changing business models, but variations in their strategic responses. Externally, the dominant factor which all banks are having to come to terms with is the impending wave of new regulation. In one way or another, this is bound to require banks to hold additional capital, impose additional costs and reduce returns. A second key factor is that capital markets are likely to remain tight for the foreseeable future; credit will be limited and liquidity constrained.

Innovation will play a key role. In the past, securitization provided a route to access capital markets. Banks will continue to need intermediaries. An intensive process of analysis is necessary to identify how to capture savings in geographies which are growing, and how to replace the previous channels of risk transfer, access to capital markets and sources of funding.

Within Europe and the US, banks are responding by shifting their focus from growth and revenue to prudent balance sheet management. The specter of tighter regulation means they are reviewing business models to concentrate on core business activities which can remain profitable in the new environment, and on streamlining operating models and infrastructure to squeeze out greater efficiencies. They are facing a more constrained and circumscribed future.

Banks have responded with sensible moves to consolidate their business. The need to hold more capital will mean that profitability in terms of return on capital will decline even as profit on turnover stabilizes. Those banks in public ownership have a greater incentive to shrink their balance sheets and dispose of non-core businesses voluntarily: this is likely to be the best way of avoiding compulsory dismemberment. While it was difficult to get a clear view from our respondents, it is likely that the process of writing off toxic assets has some way yet to run.

Away from the heart of the crisis, in Latin America, Africa and to some extent Asia, banks have a different outlook. Global external factors mean their prospects are to some extent also constrained. But assuming economic growth in these regions continues, the prospects are good for business models which target operating efficiencies, organic growth, new products and markets and some judicious acquisitions.

© 2010 KPMG International. KPMG International is a Swiss cooperative. Member firms of the KPMG network of independent firms are affiliated with KPMG International. KPMG International provides no client services. No member firm has any authority to obligate or bind KPMG International or any other member firm vis-à-vis third parties, nor does KPMG International have any such authority to obligate or bind any member firm. All rights reserved.

"Are we going to go back to the liquidity that we saw in 2005, 2006, 2007? I just do not believe so. Should we get back to a more normalized funding model which might go back to the 1990s or earlier? I think we have to."

EMA respondent

Uncertainties remain however, principally over the strength of global economic recovery and banks' role in the new financial environment. Across the major economies, banks are continuing to deleverage at a historically unprecedented rate. Despite government incentives and exhortations, this process will continue to drain credit from the global economy and act as a brake on growth. We have seen the contradictory consequences which have followed massive government intervention. It remains to be seen whether these can be unwound without fatally undermining the recovery.

A further uncertainty is when and how far the wholesale funding markets will loosen. Interbank lending remains anemic. Concerns over sovereign debt hang over the market. The two most important economic areas, the US and the eurozone, continue to throw up indicators both positive and negative. The challenge is how to interpret them. However they have yet to show decisive evidence of sustainable growth.

Developing an agenda for action

Banks are right to assume the future will be tight. In such an atmosphere of constraint and uncertainty individual business models will reflect particular situations. But all are focusing on managing capital constraints, the demands of new regulation and a long haul back to stability and normality.

The sheer volume of change – external, internal, strategic and operational – is itself becoming a significant agenda item. Banks face major challenges in prioritizing what needs to be done and in allocating scarce resources to the most pressing objectives, within a difficult business environment.

We have seen the different impacts which the crisis has had on different sectors of the banking community:

- Western banks that nearly collapsed, suffered massive losses or needed government support; here there is clearly a need for huge change in business models, operations and risk management.

- Western banks that survived, but now face a different market place (much slower growing, a need to focus on cost and customer service); these have therefore got to undertake a substantial change in approach to products, markets and customer services.

- Asian, African and Latin American banks, many of which have been indirectly impacted by the crisis, have not had to fundamentally change their strategies. For some (stronger, emerging players), significant opportunities exist for expansion.

- Asian, African and Latin American banks, which have faced considerable challenges, but whose fundamental strategies have not had to change; here the focus is as much internal as external.

"Change in our operating model depends on the change in the business model which depends on regulation. But for us it's mostly around funding. We will be more segment and deposit focused; and there will be a big drive on productivity."

Asia Pacific respondent

© 2010 KPMG International. KPMG International is a Swiss cooperative. Member firms of the KPMG network of independent firms are affiliated with KPMG International. KPMG International provides no client services. No member firm has any authority to obligate or bind KPMG International or any other member firm vis-à-vis third parties, nor does KPMG International have any such authority to obligate or bind any member firm. All rights reserved.

" Recent concern over the EU and the sovereign [debt] crisis makes me feel that [normality] may be further away than I had hoped."

EMA respondent

The first priority for any bank developing an agenda for action is therefore to determine to what extent it fits into each of these categories, and therefore what the prime strategic priorities should be. New business models then need to be developed which reconcile the external environment and core strategy. New and improved operating models are necessary both to pursue the traditional priorities of cost control, efficiency and customer service, but also the specific requirements of new business models.

Our survey shows that many banks are facing major challenges in managing this challenging agenda with limited resources in a difficult, and still uncertain, business and regulatory environment. But those that have survived this far have no alternative but to continue with this process.

© 2010 KPMG International. KPMG International is a Swiss cooperative. Member firms of the KPMG network of independent firms are affiliated with KPMG International. KPMG International provides no client services. No member firm has any authority to obligate or bind KPMG International or any other member firm vis-à-vis third parties, nor does KPMG International have any such authority to obligate or bind any member firm. All rights reserved.

© 2010 KPMG International. KPMG International is a Swiss cooperative. Member firms of the KPMG network of independent firms are affiliated with KPMG International. KPMG International provides no client services. No member firm has any authority to obligate or bind KPMG International or any other member firm vis-à-vis third parties, nor does KPMG International have any such authority to obligate or bind any member firm. All rights reserved.

Acknowledgements

KPMG International and KPMG member firms would like to thank all those who participated in the interviews for this survey, including:

ACP (Autorité de Contrôle Prudentiel)
AMP
Banco Bradesco
BAWAG PSK
BBVA
BNP Paribas
FELABAN
ICICI Bank Limited
Industrial and Commercial Bank of China
JP Morgan Chase
Lloyds Banking Group
RBS
Regions Bank
Santander
Société Générale
Suncorp Bank
UniCredit Austria
Unicredito Italy
Westpac

Special thanks

Irene Pitter, Global Retail Banking, KPMG in Germany
Amber Stewart, Global Financial Services Marketing, KPMG in the UK
Freddie Hospedales, Global Financial Services Marketing, KPMG in the UK
Adrian Curtis, Global Financial Services, KPMG in the UK
Michael Imeson, Contributing Editor, *The Banker*
Roger Pearce, Contributing Editor, *Eastbury Partnership*
Jen Hawkins, Global Financial Services Marketing, KPMG in the UK
Marcel Stephan, KPMG in Germany
Eva Maria Ahr, KPMG in Germany

© 2010 KPMG International. KPMG International is a Swiss cooperative. Member firms of the KPMG network of independent firms are affiliated with KPMG International. KPMG International provides no client services. No member firm has any authority to obligate or bind KPMG International or any other member firm vis-à-vis third parties, nor does KPMG International have any such authority to obligate or bind any member firm. All rights reserved.

kpmg.com

David Sayer
Global Head of Retail Banking
KPMG in the UK
T: +44 20 7311 5404
E: david.sayer@kpmg.co.uk

Neil Johnston
Global Head of Banking, Advisory
KPMG in the UK
T: +44 20 7311 5270
E: neil.johnston@kpmg.co.uk

Americas

Ricardo Anhesini Souza
Regional Coordinating Partner,
Financial Services, Latin America,
KPMG in Brazil
T: +55 11 2183 3141
E: rsouza@kpmg.com.br

Carl Carande
Head of Banking, Advisory, US
KPMG in the US
T: +1 704 335 5565
E: ccarande@kpmg.com

Anthony Anzevino
Head of Banking, US
KPMG in the US
T: +1 212 872 6270
E: aanzevino@kpmg.com

Mitchell Siegel
Principal
KPMG in the US
T: +1 678 592 3471
E: msiegel@kpmg.com

Asia Pacific

Andrew Dickinson
Head of Banking, Asia Pacific
KPMG in Australia
T: +61 2 9335 8952
E: adickinson@kpmg.com.au

Simon Gleave
Head of Financial Services, Asia Pacific
KPMG in China
T: +86 10 8508 7007
E: simon.gleave@kpmg.com

Europe

Pascal Brouard
Partner, Financial Services
KPMG in France
T: +33 1 5568 6996
E: pascalbrouard@kpmg.fr

Francisco J. Munoz Neira
Head of Financial Services, Spain
KPMG in Spain
T: +34 91 456 3416
E: fjmunozneira@kpmg.es

Nigel Harman
Head of Banking, UK
KPMG in the UK
T: +44 20 7311 5291
E: nigel.harman@kpmg.co.uk

The information contained herein is of a general nature and is not intended to address the circumstances of any particular individual or entity. Although we endeavor to provide accurate and timely information, there can be no guarantee that such information is accurate as of the date it is received or that it will continue to be accurate in the future. No one should act upon such information without appropriate professional advice after a thorough examination of the particular situation.

The views and opinions expressed herein are those of the authors and interviewees and do not necessarily represent the views and opinions of KPMG International or KPMG member firms.

© 2010 KPMG International. KPMG International is a Swiss cooperative. Member firms of the KPMG network of independent firms are affiliated with KPMG International. KPMG International provides no client services. No member firm has any authority to obligate or bind KPMG International or any other member firm vis-à-vis third parties, nor does KPMG International have any such authority to obligate or bind any member firm. All rights reserved. Printed in the UK.

The KPMG name, logo and the phrase "cutting through complexity" are registered trademarks or trademarks of KPMG International.

Produced by KPMG's Global Financial Services Practice in the UK.

Designed by Mytton Williams

Publication name: Creating a new mould for banking

Publication no: 100944

Publication date: September 2010

Printed on recycled material

© 2010 KPMG International. KPMG International is a Swiss cooperative. Member firms of the KPMG network of independent firms are affiliated with KPMG International. KPMG International provides no client services. No member firm has any authority to obligate or bind KPMG International or any other member firm vis-à-vis third parties, nor does KPMG International have any such authority to obligate or bind any member firm. All rights reserved.