

The 2015 Retail Banking Radar

Time to Reinvent Your Banking Model

Profitability is rebounding as Europe's retail banks recover from the financial crisis. However, future success depends on building a banking model that captures new revenues and increases cost efficiency.



The uncertain environment retail banks have faced for nearly a decade is not likely to change in the near future. Tightened regulations will likely continue to drive up equity requirements and the cost of doing business while limiting revenues. Persistently low interest rates and slow economic growth together with deflationary pressures could continue to limit profits. And changing customer demand with increasing competition from new innovative players may provide additional challenges for the traditional retail banking industry.

As risk provisions decline from the 2012 historical highs, gradual bottom-line improvement is starting to take effect. But banks are still struggling to capture new revenue pools and topline growth; despite many restructuring efforts, they still have vast room for improvement in terms of cost efficiency. The industry's forward-looking players are heading for more structural transformations of the existing retail banking model: They are adjusting their business models to the new digital era while entirely transforming their operating models.

These are among the main findings of the A.T. Kearney 2015 Retail Banking Radar, an annual study that monitors the dynamics of Europe's retail banking sector (see appendix: About the Study on page 18). This year's findings point to the sector's continued stabilization, but still at lower profit levels than before the crisis. Many banks are still only slowly embarking on the structural changes required to capture new sources of income and become more efficient.

Europe's **forward-looking retail banks** are **adjusting their business models** to the new digital era while entirely transforming their operating models.

Retail Banks in Europe: Slowly Regaining Their Luster

Despite positive signs early in the year, the European economy in 2014 remained in a state of slow recovery. GDP in the European Union increased by 1.3 percent, driven primarily by private consumption growth, as investment and exports failed to recover. Unemployment remained greater than 10 percent, and consumer price inflation continued trending downward to 0.6 percent as oil prices declined sharply. Macroeconomic forecasts for Europe are now pointing up, following the depreciation of the euro and the European Central Bank's quantitative easing; strong economic growth is not yet on the horizon, however.

The retail banking sector in Europe mirrored macroeconomic conditions in 2014, with modest recovery. Despite lower interest rates, personal deposits rose for the fifth consecutive year, by more than 2 percent. Loan volumes, on the other hand, were almost flat, increasing slightly by 0.5 percent, as both individuals and companies remained reluctant to commit to significant investments. Profitability continued its upward trajectory, with profits per customer increasing to €155, but that was mostly a result of a continued decline in risk provisions from 2012's historical highs. Profit margins remain more than 25 percent below pre-crisis levels

(see figure 1). While Europe’s retail banking sector has likely moved on from its lows—decreased incomes, high risk provisions, and low profits—the heights of 2007 are not yet in sight.

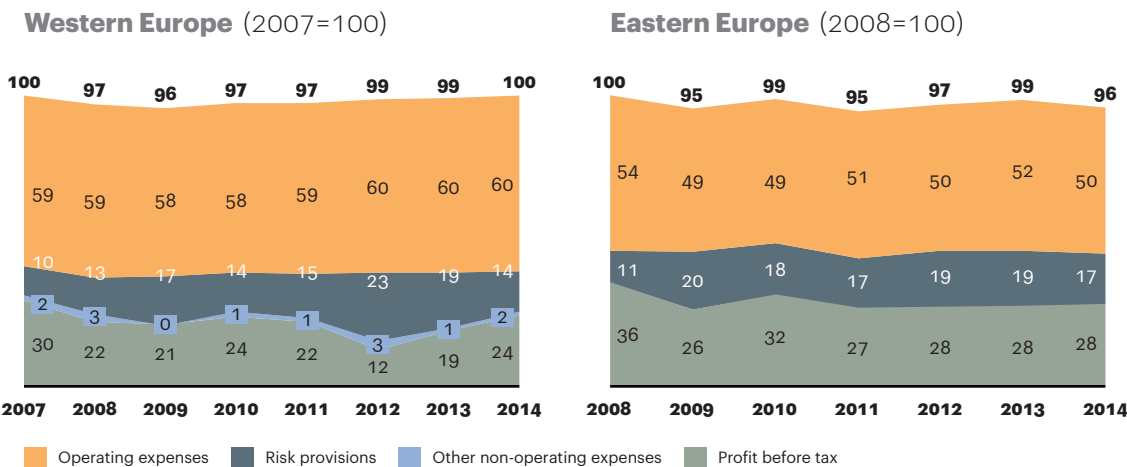
Two interesting developments are worth highlighting when looking in more detail into retail banking performance in Europe in 2014, one related to revenue generation and the other to cost efficiency.

First, regarding revenues, retail banks’ incomes remained almost flat (rising only 0.4 percent), mostly driven by net interest income growth. Banks continue to struggle to increase fee revenues, which remain at less than 30 percent of total income. Slow economic growth and lower interest rates are part of the story, but these trends also point to the fact that banks are taking too long to adjust their business models. Few have been able to improve their advisory role and become more agile and customer-oriented in order to face new competitors that are threatening to capture revenues long taken for granted.

On the cost side, despite efforts to rationalize branch structures and reduce headcount, cost efficiency remains a struggle, as few banks have made significant changes to operating models. Over the past six years, even as retail banks have reduced the number of branches by 9 percent and cut workforces by more than 6 percent, cost-to-income ratios have remained within a narrow band close to 60 percent. The retail banking sector must go beyond simple cost cutting and entirely rethink its operating model.

At a regional level, bank performance varies significantly between and within regions. Retail banks in the Nordics and Switzerland continue to generate high margins and profitability. Western European banks still experience limited revenue growth and compressed margins, as they struggle to become more cost efficient. Banks in Southern Europe have continued recovering, particularly in terms of risk provisions, but profitability remains low. And in Eastern Europe, recovery remains slow, particularly as some countries continue to be significantly affected by their dependency on other larger European economies.

Figure 1
Profitability continued on last year’s trajectory of recovery, driven by a reduction of risk provisions



Source: A.T. Kearney 2015 Retail Banking Radar

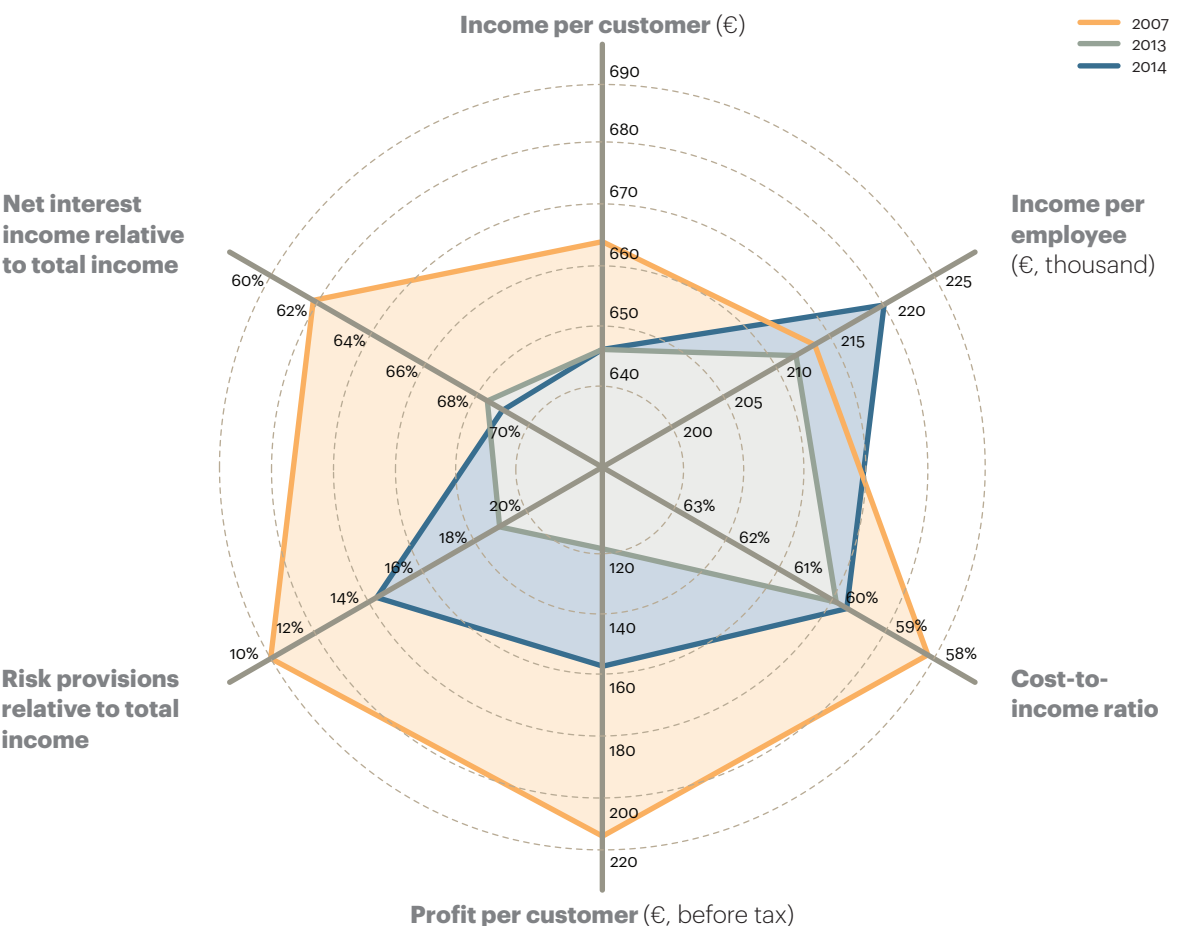
The Past: A Few Bright Spots

As in previous editions of our Retail Banking Radar, we start by looking at six key indicators, summarized in figure 2, that highlight crucial topics for the industry: the ability to realize customer potential, employee productivity, balance in income sources, cost efficiency, credit quality, and overall profitability.

This year's picture is positive at first sight, as four out of six indicators improved in 2014 compared to 2013. However, a closer look reveals that, apart from employee productivity, all indicators remain far below pre-crisis levels. In particular, profitability improvements have been driven mainly by a further decline in risk provisions after the post-crisis balance-sheet cleanup, especially in Southern Europe. The remaining indicators, especially those related to income generation and cost efficiency, remain at levels close to or lower than last year's, highlighting the difficulties most European banks face in improving the fundamentals of their existing business model.

Following is an in-depth look at the six indicators:

Figure 2
Retail banks improved in most dimensions in 2014, but only employee productivity has surpassed pre-crisis levels



Source: A.T. Kearney 2015 Retail Banking Radar

Income per customer. Most European retail banks have been unable to increase customer penetration and extract new revenue streams from their client base. Falling interest rates have put additional pressure on interest income. As a result, income per customer has remained flat for the past three years and was €644 in 2014. Only a handful of markets have shown above-average performance, namely Spain and Austria, although Spain's success is largely the result of non-recurring capital gains from disinvestments and public debt sale, while Austria saw a mild increase in demand for investments, consumer lending, and mortgages. On the other hand, some larger markets such as France and the United Kingdom still struggle due to spread compression, primarily on mortgages. In Eastern Europe, income per customer declined as a difficult economic situation in many markets made consumers price sensitive and wary of making big new financial decisions.

Income per employee. Employee productivity is the only indicator in which European retail banks have continuously improved over the past four years. At €220,000, this indicator improved once again in 2014 and is now surpassing pre-crisis levels.

Workforce reductions continue to play a much greater role in this improvement than income gains. Last year alone, banks slashed branch networks and staff by another 3 and 2 percent, respectively, which boosted employee productivity levels. Spanish banks made the most sizable leap in productivity last year through continued internal restructuring efforts, but banks in Austria, Germany, Benelux, and the United Kingdom also had significant gains, driven by workforce cuts and total income increases.

Apart from employee productivity, all **indicators remain far below pre-crisis levels**, and profitability gains are driven by a further decline of risk provisions.

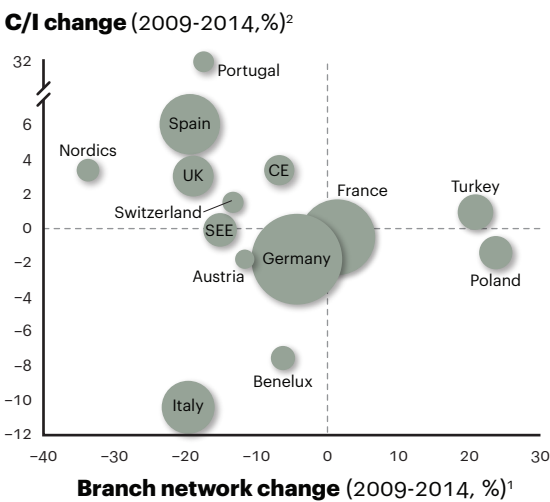
Net interest income relative to total income. Share of net interest income relative to total income continues to be well above pre-crisis level, as banks struggle to increase fee-based revenues. Over the past six years, the share of net interest income has remained almost flat, and even slightly increased in 2014 to 69 percent, compared to 62 percent before the crisis. In select countries, such as the United Kingdom and Benelux, net interest income has even risen close to 80 percent of total income. Different regulations, such as free current accounts, lending fee limitations, and caps on interchange fees, have impacted (and will continue to impact) banks' ability to generate fee-based revenues. The cap on interchange fees alone, approved by the EU Parliament in March 2015, will wipe out between €3 and €4 billion in retail banking revenues. This also demonstrates the difficulties most European retail banks are experiencing in adjusting their business models, increasing advisory services, distributing off-balance sheet products such as insurance and investment products, and raising commission income.

Cost-to-income ratio. Despite the many restructuring plans announced since the crisis began, cost-to-income ratios have remained almost flat over the past six years, oscillating in a very narrow band around 60 percent.

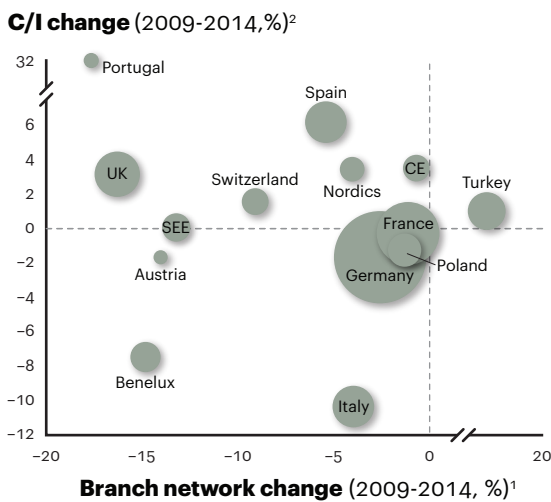
Branch network rationalizations and headcount reductions in many markets did not necessarily bring higher cost efficiency (see figure 3). Some may argue that headcount reductions, branch network rationalizations, and efforts to become digital- and customer-centric require retail banks to commit significant near-term investments in personnel severance, real estate refurbishment, and technology, and that the potential benefits will be arriving in the coming years. Although true, we believe that many European retail banks need to move forward with structural changes on both their business and operating models if they want to become more efficient and compete with agile and cost-efficient new challengers.

Figure 3
Branch network rationalization and headcount reductions did not necessarily bring higher cost efficiency

**Branch network rationalization
vs. cost-to-income ratio**



**Headcount reductions
vs. cost-to-income ratio**



¹Year-over-year change in percent

²Year-over-year change in percentage points

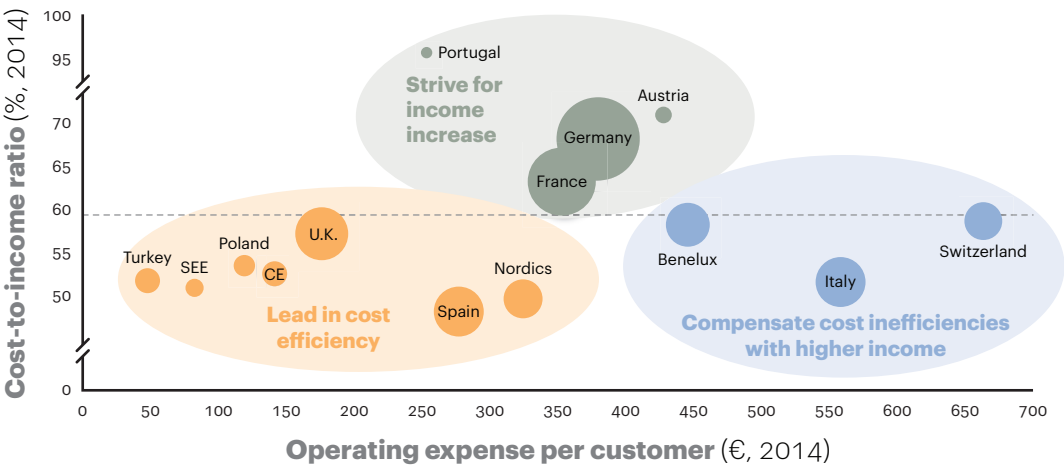
Notes: Central Europe (CE) includes Czech Republic, Hungary, Slovakia, and Slovenia; Southeastern Europe (SEE) includes Bosnia and Herzegovina, Bulgaria, Croatia, Romania, and Serbia; Poland and Turkey are tracked on their own because of size.

Source: A.T. Kearney 2015 Retail Banking Radar

A closer look at cost-to-income performance and operating expenses sheds additional light on the challenges ahead for European banks (see figure 4 on page 6). Retail banks in Spain and in the Nordics remain champions of cost efficiency, with cost-to-income ratios below 50 percent and operating costs per customer below €325. Banks in countries such as Switzerland or Italy compensate their expensive cost structure with a banking model capable of extracting the most out of their customers. Institutions in large European markets such as Germany, Austria, and France, on the other hand, have cost-to-income ratios well above 60 percent, not only due to their relatively heavy cost structures but also due to their struggles increasing income per customer. This only reinforces our view that cost efficiency is not about cost cutting alone, but must include the development of a profitable and sustainable banking model, where income improvement and operational efficiency go hand in hand.

Figure 4

Cost efficiency requires a profitable business and operating model rather than cost cutting alone



Notes: Central Europe (CE) includes Czech Republic, Hungary, Slovakia, and Slovenia; Southeastern Europe (SEE) includes Bosnia and Herzegovina, Bulgaria, Croatia, Romania, and Serbia; Poland and Turkey are tracked on their own because of size.

Source: A.T. Kearney 2015 Retail Banking Radar

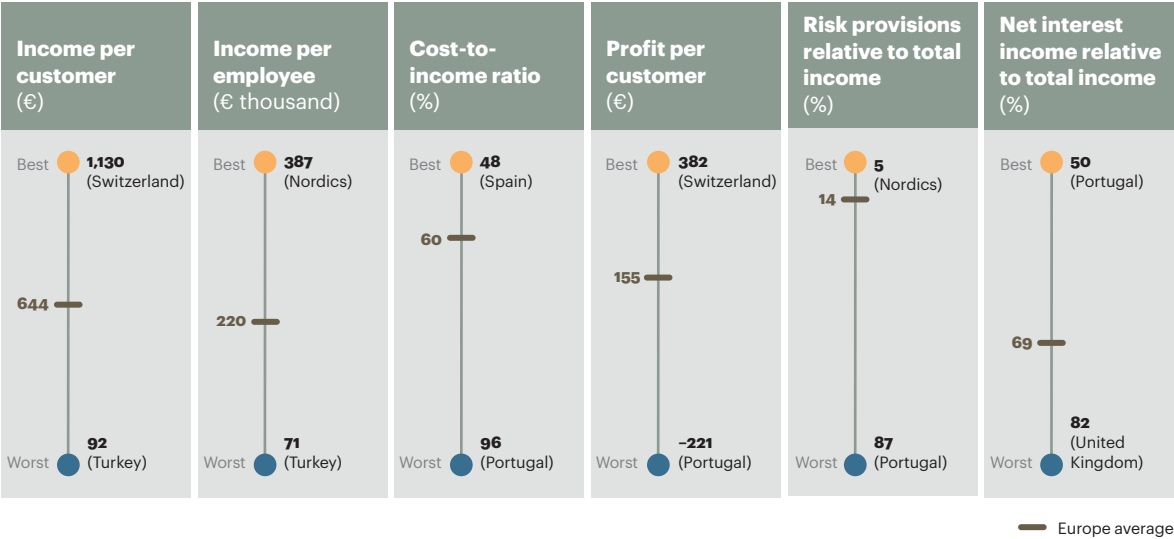
Risk provisions relative to total income. After peaking at almost 24 percent of total income in 2012, risk provisions have declined sharply, and were 14 percent in 2014, close to pre-crisis levels. Retail banks have progressed back to near normal after a couple of years of balance sheet cleanup. The creation of national “bad banks” and significant loan impairments, following the asset quality review and stress tests conducted by the ECB, have been the most common practices used. However, in some hard-hit regions such as Southern Europe (Italy, Spain, and Portugal) and Eastern European (namely, Hungary, Romania, and Slovenia), provision levels remain near or even above 30 percent. In the event of potential economic stagnation across Europe that increases unemployment, or exchange-rate fluctuations in Eastern Europe, caution remains advisable, even if European retail banks seem better prepared now with stricter risk policies and predictive models.

Profit per customer. Declining risk provisions have been key in boosting profitability. Profits increased for the second straight year, by more than 30 percent to €155 per customer, but they remain far from pre-crisis levels, particularly in Southern Europe. However, banks in countries such as Italy and Spain, which had been losing money just a few years ago, are now back to profits, and only Portugal remains in the red. Still, with profits per customer in the rest of Western Europe and Eastern Europe almost flat, the profitability challenge remains for most European banks. The solution may be in rethinking the entire business model.

One Europe, but Many Realities

Although 2014 continued the trajectory of modest recovery, different parts of Europe developed differently. The performance gap between the top and bottom quartile continues to be sizable (see figure 5 on page 7).

Figure 5
European retail banking is far from being a single market



Although there are variations within each region of Europe—different speeds of recovery depending on economic development and the “boldness” of restructuring efforts—the regional groupings from previous editions of the Retail Banking Radar continue to demonstrate interesting trends regarding the different structural and performance characteristics in Europe (see figure 6 on page 8).

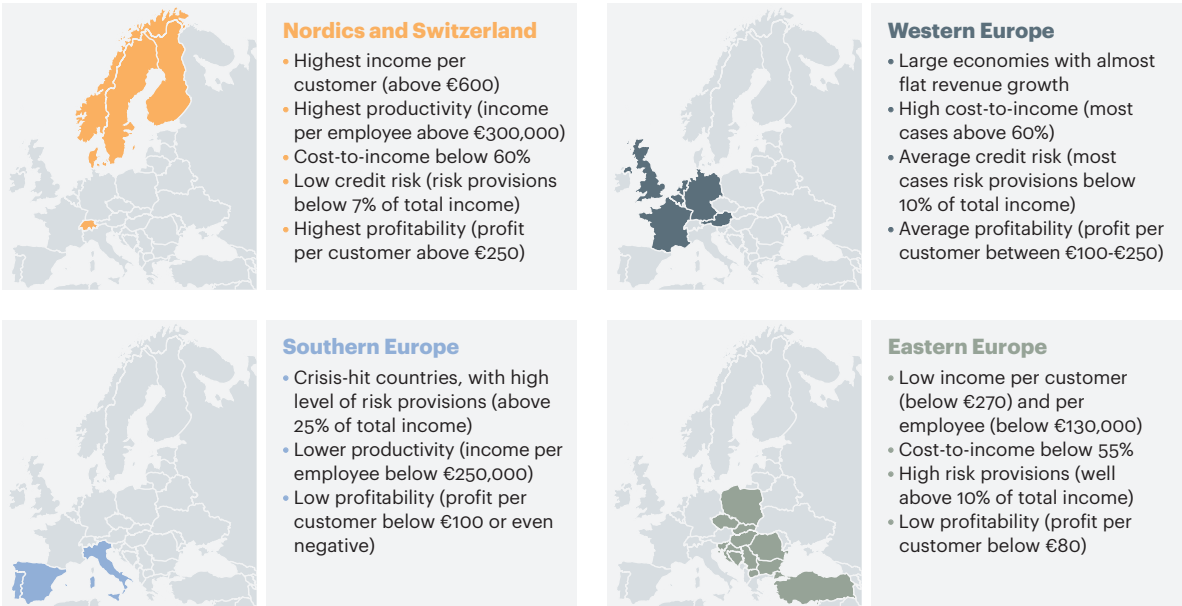
The Nordics and Switzerland: Retaining leadership. Retail banks in the Nordic countries and Switzerland continue to be the most profitable in Europe. Although they present different realities, their overall strong position reflects their historical leadership in most performance dimensions.

Swiss retail banks register the highest income per customer, consistently reaching more than €1,000 over the past eight years. They benefit from high consumer purchasing power and a unique business model, which clearly compensates for their relatively heavy cost structure. On top of that, Swiss banks benefit from the low risk of their credit portfolio to record Europe’s highest profitability level—€382 per customer in 2014.

In the Nordics, retail banks’ strong performance comes from stricter cost management and higher productivity; in 2014 income per employee increased to almost €390,000. Nordic banks benefit from a multichannel customer approach. Their digitization has not only structurally changed the way they interact with customers but also transformed their distribution and operating platforms, bringing cost-to-income ratios back to below 50 percent, the second-lowest level in Europe after Spain.

Western Europe: Mild recovery. The picture varies a bit within Western Europe, with banks in stronger economies with low unemployment, such as Germany, Austria, and the UK, recovering somewhat while banks in weaker economies such as France face a downward path. Still, there are common threads in the region’s performance. Interest margins have been affected by low interest rates, and should remain so as long as central banks keep the reference rates at

Figure 6
Structural and performance regional differences remain within Europe



Source: A.T. Kearney 2015 Retail Banking Radar

historical lows. At the same time, banks have not been able to transform their business models and increase fee-based revenues; net commission income last year only represented 27 percent of total income, down from 31 percent before the crisis. And despite the many cost reduction programs, cost efficiency remains a clear challenge for Western European banks. Cost-to-income actually increased slightly to 64 percent, well above the top-performing banks in Spain and Scandinavia.

German and Austrian banks improved profitability. They managed to increase revenues by reviving investment products in a low-interest-rate environment and containing risk provisions. However, banks in both countries are still affected by inefficient cost structures and a highly fragmented banking landscape, leading to cost-to-income ratios of around 70 percent in both cases. UK banks keep facing a highly competitive market and growing regulatory intensity, resulting in the lowest incomer per customer in the region, barely more than €300. Benelux banks’ performance remained flat in almost all indicators; despite a concentrated market with good margins, digital newcomers are offering strong competition. And profitability for French retail banks was hardest hit, dropping more than 6 percent. Cost reduction efforts could not compensate for revenue decline, with income per customer falling by almost 4 percent due to the challenging economic environment.

Southern Europe: Differing rates of recovery. Retail banks in Iberia and Italy are still dealing with the aftermath of the double-dip recession caused by the banking and sovereign-debt crises in 2008 and 2011. Yet profitability, although improving, is still low. Risk provisions remain well above pre-crisis levels but, after peaking in 2012, have fallen the past two years and were at around 38 percent of total income last year, down from 60 percent in 2013. This explains much of the profitability increase in the region.

The speed of recovery differs by country. Portuguese retail banks remain in the red, losing more than €220 per customer, with the net interest margin decline only partially compensated by non-recurrent capital gains on public debt. Italian banks did return to profitability last year, although that was mostly related to a more than 40 percent dip in risk provisions.

On the other hand, Spanish retail banking performance significantly improved, although current profitability of roughly €100 per customer remains well below the more than €320 level in 2007. Spanish banks have improved cost efficiency, with income per employee rising 9 percent in 2014 and cost-to-income dropping to 48 percent. The stronger performance has come from a sector restructuring and consolidation that has rapidly cleaned up balance sheets, reduced high-density branch networks, and streamlined headquarters (see sidebar: Spain: Accelerated Restructuring and Renaissance).

Eastern Europe: Slowly closing the gap. Eastern Europe remains diverse performance-wise, but the potential for medium-term growth is common across the region. Still, the gap with the rest of the continent is closing more slowly than expected, as demonstrated last year by drops

Spain: Accelerated Restructuring and Renaissance

Two years ago, the Retail Banking Radar highlighted the significant issues Spanish banks faced in the wake of a real state bubble burst and increased regulation. Since then, the industry has gone through a profound restructuring, shrinking from more than 60 entities to around 12. This process led to an aggressive reduction in infrastructure and costs—mainly focused on branches and employees—and has been combined with an improvement in business margins and a stabilization in risk provisions, taking cost-to-income ratios back to below 50 percent and ROE of some top Spanish banks to close to 10 percent in 2014. Main drivers of this restructuring have included:

- A significant reduction in capacity, eliminating unprofitable branches and streamlining corporate services
- Active management of margins and loan portfolios, focusing on higher-yield segments (SME and business banking, as well as affluent and private banking) and progressively reducing

exposure to real estate promotion and individual mortgages

- Immediate recognition of significant losses on non-performing loans during 2012 and 2013, allowing for a reduced impact in 2014
- Sales of non-core services and assets, including real estate management, card issuing and acquiring services, and stakes in industrial companies, some with capital gains
- Reinforced balance sheets through rights issues to reach new capital requirements, significantly increasing the solidity of the Spanish banking sector

Bankia's restructuring is a good example. In 2012, Bankia reported almost €20 billion in losses in its credit portfolio. In the past two years, Bankia has gone through a complete "revolution" of its business, cutting the number of employees in branches and headquarters by 30 percent, rationalizing its branch network by 40 percent, reducing its client

loans by 40 percent, and cutting its risk provisions down to only 24 percent of total income. Following this transformation, Bankia managed to achieve a 43 percent cost-to-income ratio and an 8 percent return on equity in 2014, which enabled the Spanish government to begin reducing its equity stake in the bank.

Spain is a good example of how profitability can be quickly recovered through a systematic approach to cost efficiency, business focus, and risk management. Spain has regained a leading position in terms of cost-to-income and profitability, and its banking industry has helped boost the economic growth of the entire country.

in income per customer (by 4 percent) and income per employee (by 3 percent). Although banks in this region did make progress in cleaning up balance sheets, the unpegging of the Swiss franc to the euro and its subsequent appreciation led to new difficulties in loan portfolios and increased the likelihood of household default, particularly in countries such as Poland, Croatia, and Hungary with a high share of foreign currency mortgages.

Polish and Central European retail banks continue to achieve higher profitability levels. Even though income per customer declined, banks in these countries maintained cost-to-income ratios of around 53 percent with reasonable risk provisions between 11 and 13 percent of total income. On the other hand, banks in Southeastern Europe continue to face serious economic conditions. There, non-performing loans remain a significant challenge, with risk provisions amounting to 32 percent of total income.

Lastly, Turkey, not long ago a major growth market, is visibly slowing down. Most indicators dropped in 2014, with profit per customer falling by almost 15 percent. Although this was partially due to the lira's 13 percent depreciation compared to the euro, regulatory limitations, including caps on fees and commissions, restrictions on consumer loans and credit cards, and a slowing economy, are also limiting revenue growth and increasing the numbers of non-performing loans.

Looking Ahead: Seeking to Speed Up a Slow Recovery

According to the ECB, eurozone banks' return on equity was only slightly above 3 percent in the first half of 2014, far from the 10 percent registered back in 2007.¹ Although we expect the retail banking industry to proceed on its slow recovery path in 2015–2016, particularly as risk provisions gradually fall in line with economic recovery, we do not see most banks developing business models capable of generating shareholder returns well above the cost of equity. In fact, banks will face—or are already facing—major challenges that affect their future profitability.

Changes in customer demand and new competitors will threaten traditional business models.

Internet and mobile banking are becoming the main contact points for customers with their banks. As customers increasingly value simplicity, transparency, and convenience, digital has become the new battleground for differentiation.

Digital readiness varies by market and by bank. We expect changes in technology and customer demand to affect sector performance significantly, as new competitors from adjacent industries and financial technology start-ups are emerging in the market with innovative, technology-driven deviations from the traditional banking model.

Income and profitability will soon be significantly impacted as new competitors capture traditional revenue streams—for instance, on payments, peer-to-peer lending, and personal financial advice—while incumbents' high-cost business models remain in place.

Persistently low interest rates and deflationary pressure will hamper profits. With low (and even negative) yields for eurozone government debt and the launch of quantitative easing by the ECB, the already-prolonged period of low interest rates will likely last much longer than was expected at the beginning of the financial crisis.

¹ Return on equity is total profit (or loss) after tax and discontinued operations divided by total equity, as determined by the European Central Bank. This is for all domestic banking groups and standalone banks in the eurozone.

Bank balance sheets and financial strategies will be materially impacted. If deflationary trends emerge, profitability will likely fall as customer demand for personal loans decreases. This effect will be most pronounced in economies with traditionally high levels of both debt and discretionary purchases.

On the liability side, lower interest rates will reduce demand and potential margins of savings products, also contributing to reduce profitability.

Increased regulation will reduce profitability. Regulation has been a fact of life for financial services since the banking crisis, and there are no signs of let up over the next few years as the risks the industry is exposed to become clearer and the political environment remains focused on maintaining control.

Western European banks have felt a greater impact from regulation, but looking ahead, regulatory changes are coming for all of Europe.

Regulations have many effects on retail banking results: reduced income (for example, from the consumer protection regulation or from the Payment Services Directive and regulations on interchange fees), an increased cost of doing business (for example, from Basel III capital and liquidity requirements), additional restructuring costs (for example, ensuring operational continuity in resolution), and forced business divestment (see figure 7).

Figure 7
Tighter regulation is impacting overall profitability in Europe's retail banking sector Not exhaustive

Category	Main regulatory measures	Impact on returns
Capital and liquidity requirements	<ul style="list-style-type: none">• Increase minimum common equity capital ratio• Introduce conservation buffer in 2016 (increasing in 2019)• Introduce mandatory leverage ratio in 2018• Introduce liquidity coverage ratio in 2015 (increasing in 2019)• Introduce the net stable funding ratio in 2018	<ul style="list-style-type: none">• Increased equity requirements• Decreased exposure to more risky products• Possible forced divestment from capital-intensive businesses• Increased cost of funding
Consumer protection requirements	<ul style="list-style-type: none">• Implement policies to guarantee fair client treatment (consumer protection legislation)• Implement know-your-customer guidelines and anti-money laundering standards• Review deposit guarantee schemes by the European Union• Implement the EU's Consumer Credit Directive• Implement the Markets in Financial Instruments Directive II (MiFID II)• Implement Payment Services Directive and regulations on interchange fees	<ul style="list-style-type: none">• Limited revenue generation potential• Increased costs to adjust IT systems and operations to guarantee compliance
Operational requirements	<ul style="list-style-type: none">• Implement proposals on operational continuity in resolution• Implement proposals for separating retail and corporate investment bank activities	<ul style="list-style-type: none">• Increased costs of doing business and restructuring costs• Possible forced business divestment

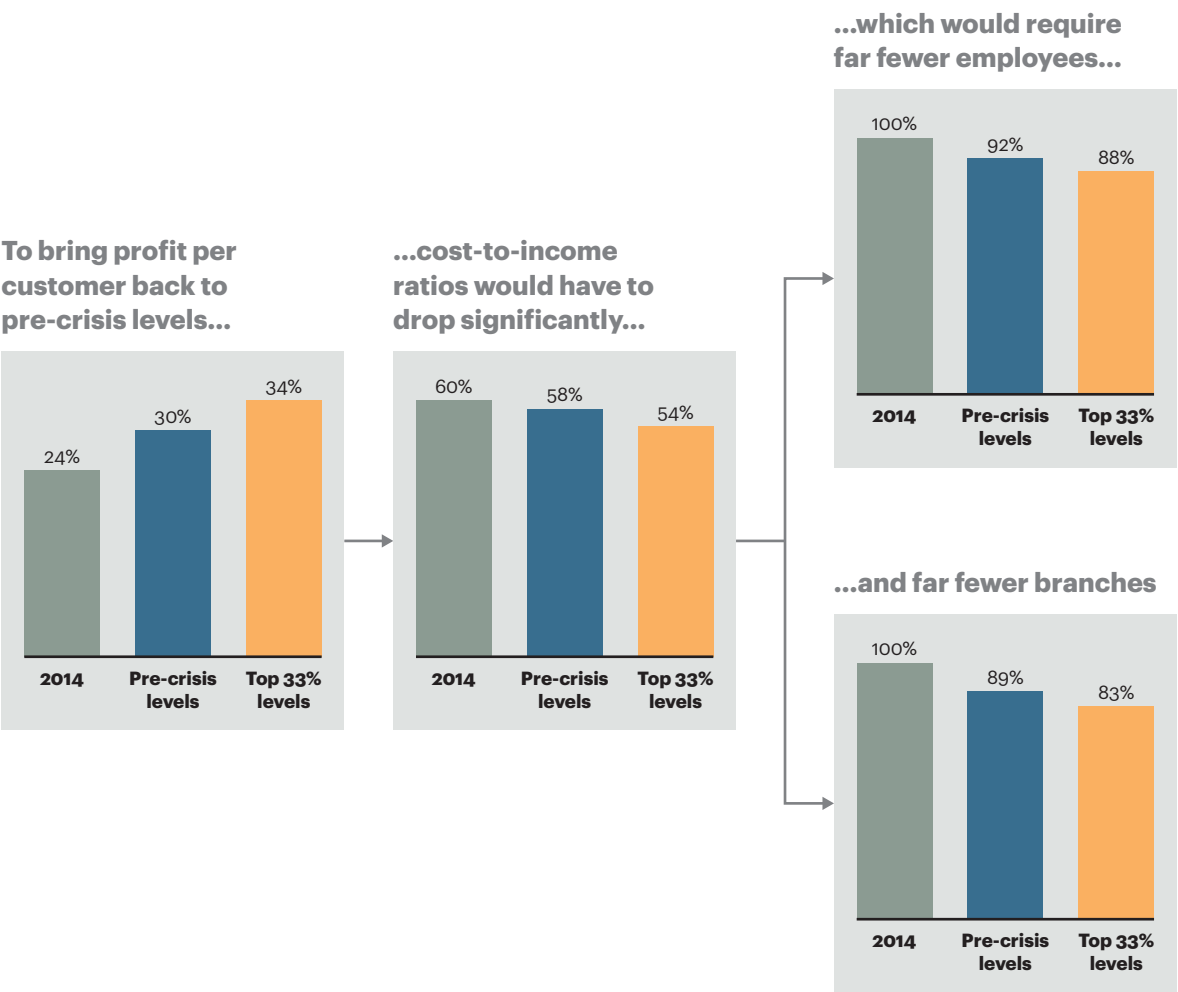
Source: A.T. Kearney 2015 Retail Banking Radar

Regulation has, of course, had benefits in improving the strength of the banking system. However, at the same time it has created conditions of uncertainty and change that have impacted the entire business and operating models of retail banking.

Looking ahead, we have simulated and quantified the challenges facing European banks as they aim to succeed in an environment of flat income and only gradual reductions in risk provisions. In this context, bringing profitability back to pre-crisis levels—or, even more aggressively, into a top-third performance—without any corresponding increase in incomes and only minimal reductions in risk provisions would require European retail banks to reduce cost-to-income ratios significantly. This would require further and even more severe restructuring of branch networks and headcount than that which has occurred in the past six years (see figure 8).

That brings us back to the urgent need for structural changes in retail banking models that would enable banks not only to improve cost efficiency but also increase topline results.

Figure 8
Cost cutting is not enough to boost profits amid flat incomes and minimally reduced risk provisions



Note: Results assume stable income and a decrease in risk provisions of 20 percent. Employee and branch numbers assume the following split of operating costs: 60 percent front-office costs (70 percent personnel and 30 percent other direct costs), 10 percent corporate center personnel, and 30 percent other indirect costs (including IT and marketing).

Source: A.T. Kearney 2015 Retail Banking Radar

Building a Banking Model for the Future

Challenges and opportunities are closely linked in retail banking. Although many challenges lie ahead for the traditional retail banking industry, potentially affecting its future profitability, those banks that keep a close eye on market developments and trends may actually find a wealth of untapped opportunities.

Among the trends we identified in last year's Retail Banking Radar, some have become a must for successfully operating in retail banking. However, after years of stagnation both on the topline and cost sides, only a profound change to banks' traditional banking models can provide a sizable profitability boost. Identifying and tapping into additional revenue pools will gain new urgency; at the same time, interesting new opportunities to grow both organically and inorganically will emerge.

Although **challenges lie ahead for the traditional retail banking industry**, banks that keep an eye on market developments may find untapped opportunities.

Here are our priorities for the coming year:

Reinvent your banking model for the digital era. Most traditional banks are planning, constructing, or experimenting with different digital strategies, not surprising as the client base will become increasingly digital in the next 10 to 15 years.² By no later than 2030, digital natives will represent half of the addressable banking population and will have ever-more purchasing power. The technology landscape will change as well, and mobile will become a crucial aspect of any digital strategy. By 2020, more than 80 percent of mobile devices sold will be smartphones, up from 50 percent today. Consumers will grow increasingly connected, with the extensive proliferation of devices (including smartphones, tablets, and watches), the availability of data and cloud services, and an explosion in virtual relationships.

Retail banking's digital future will look radically different. Digitized customers and interfaces will usher in new purchasing criteria and new rules of interaction. Convenience will increasingly be more important than loyalty, as simplicity, speed, and security become key to winning over existing customers and enticing new ones. Banks' performance track record will become more important than price, demand for price transparency will become natural, and clients will become ready to pay for premium performance. As customers increasingly trust technology and social media, crowd intelligence and peer opinions will become more important than sales staff. Tuning into the new digital client mindset will require banks to continuously focus on the customer and technology innovation, and revisit the way their organizations operate.

The burning challenge on the road to digital strategies is cultural transformation—that is, purposefully linking the digital and traditional worlds. Pain points such as balancing declining branch profitability with still minimal revenues from digital and finding a meaningful tradeoff

² For more about digital, see [Banking in a Digital World](#) and [Going Digital: The Banking Transformation Road Map](#), two A.T. Kearney research studies developed in conjunction with Efma.

between the speed of digital transformation and the inclusion of the “traditional” part of the organization are top of mind for most institutions.

In this digital environment, strong leadership is critical. Bank leaders must embody the inclusiveness of digital for their companies to transform effectively. They must ensure that all generations can digest new technologies, that IT and marketing can deliver relevant solutions to clients, and that best practices are in play between the traditional and digital sides of the business.

Look for new revenue pools and topline growth opportunities. Topline growth has dipped in many European markets during the past seven years. And as cost optimization expectations fail to materialize and reductions in risk provisions gradually wane, it has become clear that experimenting with existing models and looking for new revenue pools will only grow more important.

The upcoming year will be pivotal as banks redirect more effort and attention back to topline themes, which should remain a top strategic priority for every retail bank CEO. Yet, the headwinds haven’t died down. Banks will still have to contend with a difficult economic environment, cautious consumers, competition from alternative providers, gradual commoditization of traditional banking products, and regulatory requirements and limitations—just to name a few.

The topline battle throughout Europe will be about capturing the wallet share of existing clients. However, new challenger players are emerging and increasingly capturing a large share of traditional banks’ revenue pools. In payments, digital wallet solutions (such as Apple Pay) and person-to-person payments (PayPal and others developed by banks and card companies) are being well received by consumers. In consumer credit, peer-to-peer lending is making inroads (the UK’s Zopa is a prominent example, having issued loans amounting to more than €1 billion). In micro and small business lending, crowdfunding is quickly evolving (for example, the Funding Circle, one of the largest debt platforms for small- and medium-sized enterprises, has originated loans worth close to €1 billion to more than 8,000 businesses). In advisory services, personal financial management tools are paving the way to support clients’ quest for transparency and convenience.

Traditional banks still have one major advantage: existing client relationships that can be leveraged to build exceptional emotional connections and loyalty in an environment where products are becoming increasingly commoditized. But that advantage is quickly eroding. Banks need to develop inspiring, leading-edge products and services to contend with rising technology players known as “fintech.” Understanding client needs, offering convenient, relevant, and personalized products and services, and having the ability to connect with customers will be key to contending with these challengers and capturing additional revenue.

Technology is the backbone of such an approach, starting with data intelligence of internal and, increasingly, external data sources. This external data includes online purchasing behavior, social network presence, affiliations, and posting sentiments. Banks will need strong analytic engines capable of identifying the next best product offers or upcoming client events. And finally, partnering with some of the new challengers to accelerate innovation may become critical to succeed in the future financial services industry.

Rethink your operating model. Most European retail banks remain far above optimal cost-to-income ratios of 45 percent or lower. While cost efficiency has been on the top of most banks’ agendas since the beginning of the financial crisis, only in a few places, such as Spain and the Nordics, have the efforts generated compelling results. Cost reductions are often managed in line with revenue expectations, and many structural changes to banks’ operating models are yet to come out of paper.

However, the need to reinvent the traditional banking model into the digital era will also create a unique opportunity for banks to rethink their operating model. But this transformation is not simple. Banks will need fully digital products and straight-through processing capabilities. Opening an account can no longer take hours or even days to occur and require extensive paper documentation; clients must have immediate online access to their new account and the ability to use their virtual cards, make deposits, payments, and credit transfers, and invest online. Number26 offers one of the first current accounts tailored to smartphone users. Account opening is managed remotely, without any paper documentation required and less than 10 minutes needed to complete and activate.

Similarly, getting a mortgage or personal loan can no longer take weeks; some banks are developing pre-approved credit processes that allow clients to get their loans almost immediately. For example, customers of Poland's mBank, owned by Germany's Commerzbank, can get loans approved in 30 seconds through their smartphones, use Skype to talk with customer service agents, and receive all statements electronically. Non-bank competitors such as Kreditech already offer loan approvals within minutes for both existing and new clients. They also use various data sources—often Internet-based—yielding thousands of individual data points for measuring credit worthiness.

The need to reinvent the traditional banking model into the digital era will **create a unique opportunity for banks to rethink their operating models.**

Operations need to be centralized and industrialized, preferably using an externalized and specialized factory model to accelerate change. This will require banks to build capabilities for a digital transformation—which implies breaking the silo-organization structure common with traditional banks—and create a new culture involving most areas within a bank (operations, commercial, marketing, IT, organization, risk, and compliance, among others) in the operating model transformation process.

Consider M&A opportunities for a post-crisis comeback. After a five-year slowdown in banking sector M&A, all signs point to a rebound. Credit quality, while lower than before the crisis, is more transparent—and it's improving. Purchasing multiples are still well below pre-crisis levels in many European markets. For banks with sufficient cash in hand, there is a window of opportunity.

Many small institutions face the burden of heightened regulatory and compliance costs and recognize that scale is needed to operate efficiently in the current market. The beneficiaries will likely be mid-sized banks with growth ambitions and large banking groups that are selectively refocusing and cleaning up their footprints and business profiles.

In parallel, institutions needing extensive technology innovation and customer data may turn to M&A as a way to speed up in-house development of their digital business models—Citibank's purchase of PayQuik and Spanish bank BBVA's acquisition of online bank Simple are just a couple of examples. Simple, which was acquired in February 2014, is for the time being remaining in a separate structure, but it is already giving BBVA additional capabilities to pursue its bold

Africa: Pockets of Strong and Profitable Growth

Africa is home to seven of the 10 fastest-growing countries in the world, with a growing and urbanizing middle class, ongoing improvement in manufacturing and productivity, and increasing local and foreign investment. The financial services industry has surpassed that growth, increasing its share of total GDP from 11 percent in 2010 to a projected 19 percent in 2020.

Despite political instability, poor infrastructure, and low income levels, banks have found economic models that have yielded high revenue streams and healthy profits. For example, prominent banks in East Africa are yielding up to 52 percent pre-tax profit, and those in English-speaking West Africa are generating up to 35 percent pre-tax profit (see figure).

The overall growth story for Africa is positive, but consumer

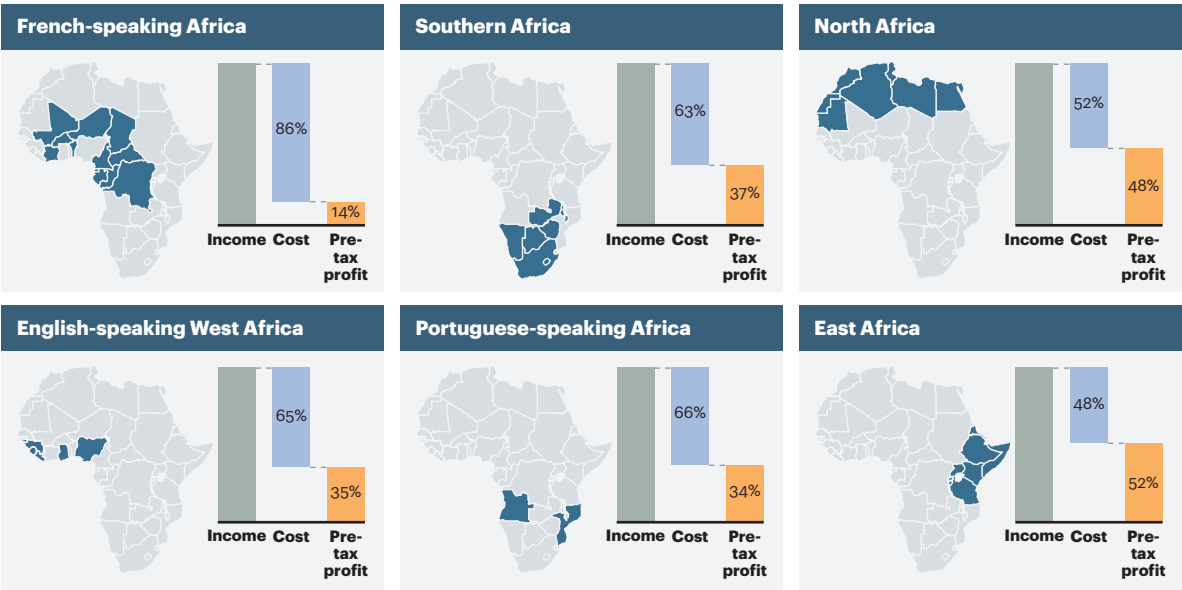
purchasing power and financial access remains low in many countries. In larger countries such as Nigeria and Ethiopia, branch concentration is minimal and the average individual net worth is roughly \$4,000. In addition, cross-border differences—most importantly regulations, but also language and culture—are difficult to navigate for banks seeking to address a region rather than a single country. Banks also need to adapt to dual markets—volume versus value—with increasing competition from non-traditional players such as telecommunications companies, which are seeking low-cost models to serve the volume markets. Finally, infrastructure throughout Africa remains a challenge, from electricity to technology.

Therefore, while profitable opportunities await in Africa,

banks entering the market need to consider the following:

- **Understand structural complexities.** Be prepared to adapt and simplify operating models and governance structures, ensure end-to-end adherence to multiple regulation frameworks, and hire or partner with the right local leaders.
- **Become digital ready.** Embrace digitization with a particular emphasis on low-cost economic models to serve the volume market and be open to partnerships with non-financial institutions.
- **Ensure that profitability is not compromised.** Understand segment profitability and adapt service levels accordingly while developing tailored services and products aligned with the different segment needs.

Figure
Retail banking in Africa has yielded high revenue streams and healthy profits



Note: Income calculation includes only interest and non-interest income; cost calculation includes risk provisions.
Sources: Banker, annual reports, press reports; A.T. Kearney analysis

transformational strategy to “become the world’s first digital global bank.” A recent analysis by A.T. Kearney shows that banks’ returns from acquiring technology companies far exceed those from acquiring other similar banks.³ Some of these acquisitions offer unique capabilities to accelerate a bank’s back- and middle-office transformation. Others may offer the mobile and social media capabilities that will help banks serve young, tech-savvy customers.

Lastly, since strong economic growth is not on the horizon soon in Western Europe, retail banks should look for growth and M&A opportunities in other parts of the globe. Several banks have expanded into emerging economies in Eastern Europe, and others have built a strong presence in Latin American countries. A few have moved into Africa, which holds enormous long-term potential (see sidebar: Africa: Pockets of Strong and Profitable Growth on page 16). Yet, banks considering opportunities in these markets need to understand their structural complexities and be able to develop low-cost digital business models capable of serving the large-volume mass market in a profitable manner.

Building a Bright Future

For most retail banks, 2015 will likely be a year of modest recovery, which may hinder them as they face the major challenges that lie ahead of the traditional banking industry. If banks do not prepare in advance for upcoming changes in customer demand, technological innovation, and regulatory requirements, they will soon find challengers taking away business. Those that reinvent their banking models, become more customer-oriented, and embrace innovation and efficiency can be the winners of the future.

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³ For more information, see “[If You Can't Beat Them... Buy Them](http://thefinancialbrand.com/44750/banking-technology-merger-acquisition-study/),” at <http://thefinancialbrand.com/44750/banking-technology-merger-acquisition-study/>

Appendix

About the Study

For the 2015 Retail Banking Radar, we tracked nearly 100 retail banks and retail banking divisions in 24 European markets. Forty-six banks are in 13 Western European markets: Austria, Belgium, Denmark, France, Germany, Italy, the Netherlands, Norway, Portugal, Spain, Sweden, Switzerland, and the United Kingdom. (The Nordics and Benelux are clustered to obtain meaningful regional samples.) Fifty-one banks are in 11 Eastern European countries, clustered into four markets: Central Europe (the Czech Republic, Hungary, Slovakia, and Slovenia), Southeastern Europe (Bosnia and Herzegovina, Bulgaria, Croatia, Romania, and Serbia), Poland, and Turkey.

The Radar covers more than half of the retail banking market in the markets we analyze; in some countries with high banking concentration, it is as high as 80 percent. The study includes almost 580 million retail banking clients served in more than 110,000 branches across Europe.

The study analyzes banks in several dimensions: income per customer, income per employee, net interest income relative to total income, cost-to-income ratio, risk provisions relative to total income, and profit per customer (before tax). The data comes from official bank records and covers January 2007 through December 2014. Bank records include different definitions of retail banking, especially in the treatment of business and commercial customers and the thresholds at which such customers move to separate wealth management and corporate banking segments. A few banking groups are included despite the absence of segment reporting because of their importance to their individual markets (for example, savings banks in Germany and Austria). In a few cases, we apply expert assumptions in the absence of a wider segment report. Differences with past reports are due to changes to the sample and readjustments of figures by banks.

Definitions

Customers refer to the total number of retail banking customers counted by the bank, not account numbers or relationships, and independent of the level of client activity. They typically include affluent clients with assets under management up to €1 million, and business clients with annual turnover of up to €5 million.

Employees are total front- and back-office staff on the bank payroll, as reported by the bank. In a few cases, we estimate numbers at the segment level.

Income refers to net banking income, including net interest income, net commission income, net trading, and other income.

Operating expenses are operational and administrative expenses without impairments and remain as stated. There is no normalization for different accounting principles applied.

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The signature of our namesake and founder, Andrew Thomas Kearney, on the cover of this document represents our pledge to live the values he instilled in our firm and uphold his commitment to ensuring “essential rightness” in all that we do.

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