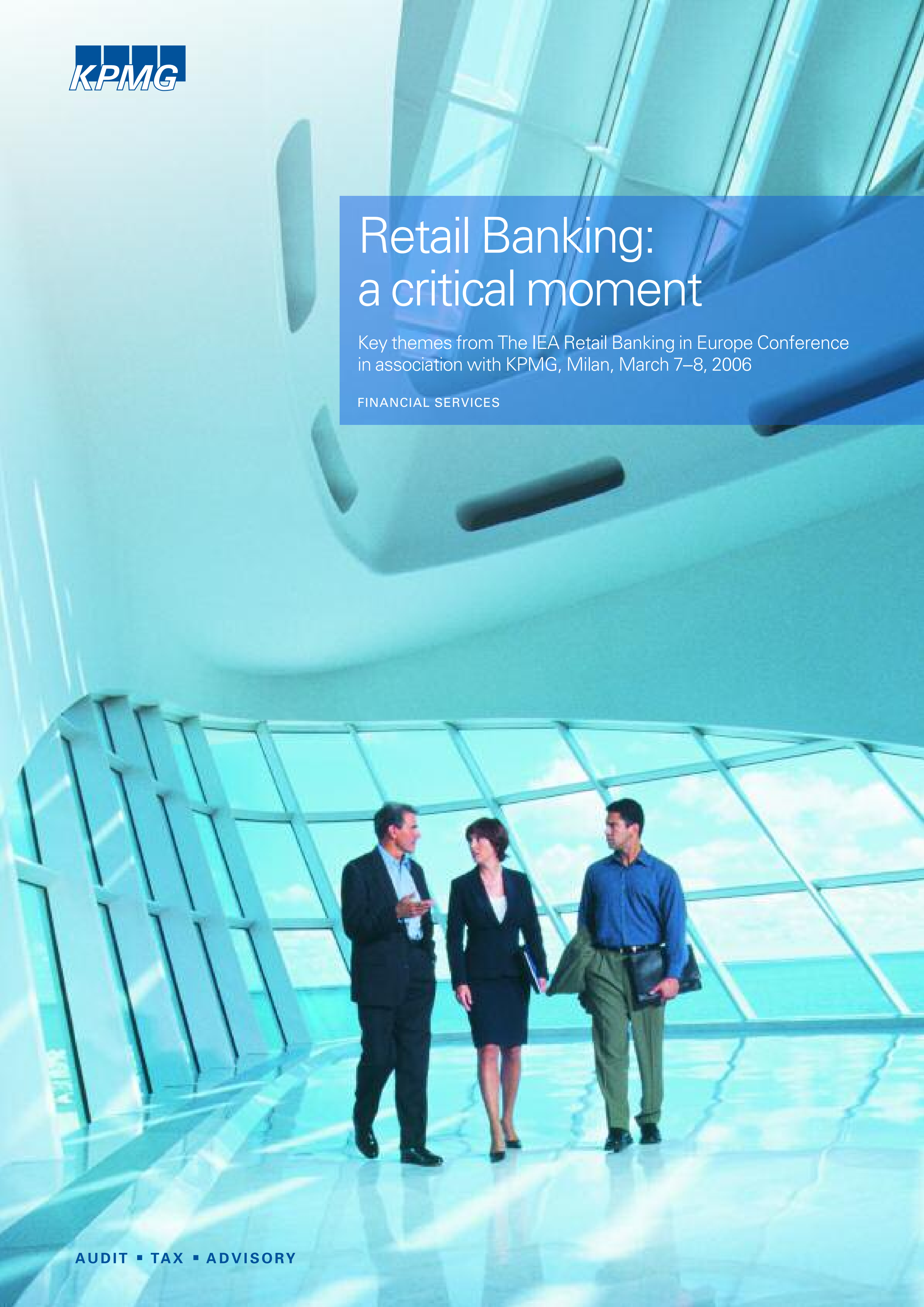

KPMG

Retail Banking: a critical moment

Key themes from The IEA Retail Banking in Europe Conference in association with KPMG, Milan, March 7–8, 2006

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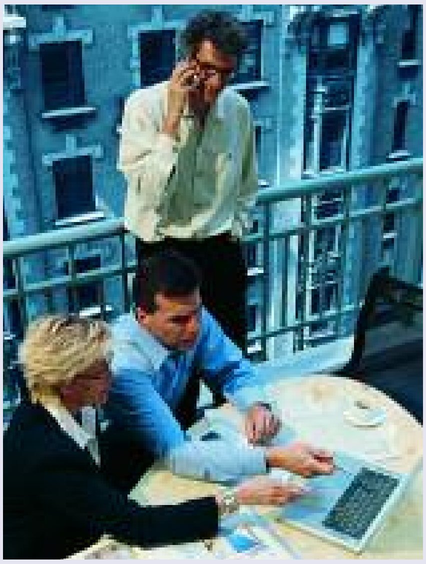

Inside

Introduction

This paper explores the key themes that emerged from The Institute of Economic Affairs' (IEA) Retail Banking in Europe Conference in association with KPMG, which was held in Milan in March 2006. The conference was attended by 150 senior decision makers from European and non-European banking organizations.

With a breakdown of political and cultural barriers within the EU, expansion across borders is a real possibility.

A critical moment
Despite increasing competition and pressing regulatory challenges, the European retail banking industry has the potential for real growth within the EU and beyond. This is a pivotal time for Europe's retail banks. The ever-changing regulatory requirements such as Basel, MiFID and anti-money laundering are swallowing up huge resources, while an ageing population in many markets is forcing a re-think of customer strategies. Technology is helping new low-cost operators to squeeze margins, and risk management, particularly for credit and operational risk, is moving up the executive agenda.

However, there are also some excellent opportunities open to the industry. The expansion of the EU and the continued growth in Turkey means that there is the chance to penetrate vibrant markets with young populations. Outside Europe, the 'BRIC' countries (Brazil, Russia, India and China) offer enormous potential for those who can establish a foothold. Despite competitive pressures, banks can still grow organically by developing new, improved products and more effective targeting of customer segments, such as the elderly and mass affluent. With a buoyant global economy and a breakdown of political and cultural barriers within the EU, expansion across borders is a real possibility.

The impact of consolidation
Compared to the U.S., consolidation has been slow and sporadic, although there has been a recent flurry of high profile cross-border deals, including ABN AMRO, Banca Antonveneta and UniCredito's acquisitions in Austria and Germany, plus BNP acquiring BNL.

With many bank CEO's boldly forecasting double digit growth for the forthcoming years, more mergers and acquisitions activity can probably be expected, as such a rate of expansion is very hard to achieve through organic means alone.

Encouragingly, the EU is increasing its involvement in cross-border activity and will stand up to both national governments and central banks that try to use anti-competitive measures against incoming rivals.

The losers in the consolidation game could well be the intermediate banks, squeezed out by the major players who can exploit economies of scale and raise capital and equity to fund further acquisitions. There should, however, be plenty of room for smaller niche players, focusing on specific geographical or product areas. Again the mid-sized banks are at a competitive disadvantage, having less speed and flexibility.

One universal issue that will not go away is customer service. Those banks that continue to listen to customers and promote a service culture across every part of their organization should be able to remain a step ahead. The fact that many of Europe's retail banks are in the process of expanding their branch network is a sign that customers still demand a personal service that cannot be achieved purely via remote channels.

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Growth and business development
Will there be pan-European super banks?

Competitive pressures in home markets and opportunities in developing countries are leading to a rise in cross-border banking activities. Will this ultimately lead to a small group of dominant players?

Banking is one of the few sectors in Europe that has yet to experience major consolidation. However, with limited domestic opportunities for growth, and competition from new players, there has been a rise in cross-border transactions in both mature and emerging markets.

Banking has traditionally not seen the same intense level of competition as many other industries, with the majority of banks making returns above the cost of capital. But factors such as excess capacity, commoditization, technology, new regulations and changing consumer demands, along with the emergence of new, low-cost providers, is putting a downward pressure on margins, forcing banks to seek out new sources of income.

Expansion can bring economies of scale in back-office functions (particularly IT), leading to cost advantages, while the convergence of accounting standards should also help cut the cost of running operations in more than one country. However, with many national governments creating domestic banking champions, it can be a real challenge to succeed outside your home market.

Where to expand – and how?
To date the majority of transactions have involved domestic banks, but there are increasing non-domestic opportunities, particularly in Central, Eastern and South Eastern Europe, as these economies continue to grow and develop. Both in terms of branches and financial services as a percentage of GDP, many markets in these regions are under-banked.

Of all the potential European markets, Turkey is clearly the largest, followed by Ukraine and Poland. Turkey has enormous potential with a young population of 72 million and relatively low take up of loans and deficits. Banks, such as Fortis, BNP and GE, are already moving in and the banking system has consolidated from 81 to 41 in five years. Mortgages and credit cards are both key areas for opportunity; as to a lesser extent are mutual funds and pensions. A successful quest for EU membership can only increase Turkey's attractiveness.[1]

Acquisitions, primarily of former state-owned institutions, are a popular entry strategy, although there has been a rise in other methods including partnerships, distribution agreements, alliances, joint ventures and even the

The majority of online users are looking for multi-channel banking that includes branches.

Banking is arguably the only sector in Europe that has yet to experience major consolidation.

creation of greenfield subsidiaries. Competition has seen the price of acquisitions escalate and buyers need to exercise extreme caution to avoid paying too much. It can be notoriously difficult to achieve a good cultural fit and the importance of local knowledge and contacts should never be underestimated.

Banks should also beware of following the 'herd' instinct too closely and chasing opportunities beyond Europe in the BRIC countries. Virtually everyone is trying to get a foothold in China, which will have an impact on margins.

Unifying brands

So far there has been a very cautious approach to brands, with many banks choosing to retain the existing name of banks they acquire abroad – and in some cases in the domestic market. Many local or regional banks have very strong brand reputations that the buyer is loath to dilute.

No single retail brand has managed to cross borders on a significant scale to achieve a genuine European presence; although new entrants such as ING have proved that you can succeed with a single positioning.

There is clearly a degree of customer homogeneity in terms of basic products, but equally there are noticeable differences in core consumer values between countries, and these need to be addressed in brand positioning. For example, 'trust' is considered the number one brand value for banks in Italy (following recent financial scandals), whereas German consumers are more concerned about 'competence'.[2]

Online banking: opportunity or threat?

The Internet is an important channel that banks may not be able to ignore, as customers increasingly expect to be able to carry out transactions online. The growth of online banking has been strongest in the U.K. and Scandinavia, with usage in Germany also growing quickly. By the end of 2004 there were almost 60 million users across Western Europe, compared to only 15 million for the whole of the U.S.[3]

The industry has also seen the emergence of a number of Internet-only banks, some standalone operations, others as sister brands of established players. Operators such as ING have built an entirely new business model based upon low-cost operations, very similar in style to the 'no frills' low-cost airlines. Retail banking, with all its inherent infrastructure costs, cannot hope to replicate such a model and will inevitably continue to lose market share.

The majority of online users are, however, looking for multi-channel banking, including branches, ATM's and telephone contact, so it's wise to view the Internet as a vital – but not exclusive – sales and delivery channel.

One of the keys to success in online banking is simplicity of use and simplicity of product. Online loans, savings and insurance have proved very popular, while more complex services may be best provided through the branch.

The next 10 years

The future structure of the industry is still uncertain. Until one bank makes the bold attempt to create a genuine pan-European brand, the sector will remain relatively fragmented. Specialist providers will continue to focus on niche segments, often with lower-cost business models. This pressure on margins will force the large banks to seek growth beyond their traditional range of services – either abroad or through innovative new products. To succeed on a cross-border level, the big banks must find a way to preserve the autonomy and the entrepreneurial spirit found in local and regional banks while exploiting the economies of scale.

1 European Union Statistics (2005)
2 Banking Beyond Borders: Will European consumers buy it? (July 2004)
3 Wharton (2005)

Growth and business development
Customer service and quality: winning hearts and minds

A relentless focus on customer satisfaction can bring genuine competitive advantage.

Despite all the efforts and initiatives of the past two decades, the quality of service offered to bank customers can vary enormously. There is, however, growing evidence that quality programs can lead to real improvements in customer satisfaction, cross-selling, business growth and profitability.

With many financial services products becoming relatively commoditized and new ones easily replicated, excellent service can be a key differentiator. Any quality program needs total commitment; a top-down approach with clear, effective communications, training and continuous measurement. It's imperative that employee incentives are linked directly to quality measurements such as customer satisfaction.

Ongoing measurement of customer satisfaction is time-consuming and expensive, but is absolutely necessary – even on a branch-by-branch basis – to help ensure continuous improvement. Share of wallet is one of the holy grails of banking, leading to greater profitability and customer loyalty, so relationship building should be based upon selling multiple services.

Customers also feel that many products are over-complex and confusing. Simplicity, of both products and marketing messages, should help raise customer satisfaction and sales. Another area in need of a shake up is documentation and authentication. Opening new accounts and mortgages requires a mountain of documents and is very time-consuming. Speeding up these services through technology, such as radio frequency identification and electronic signatures, should improve the customer experience considerably.

Channel strategies

With the rise of the Internet, banks must develop a coherent channel management strategy. Whether in the branch, online, by phone, via ATMs or through the mail, the overall brand experience should be consistent. There is a growing belief that cross-selling can be best achieved in branches and that the various channels should be aimed at driving customers into branches.

Consequently channels should complement rather than compete with each other, with each customer touch point an opportunity not only to sell but also to enhance the overall brand experience.

Each customer touch point is an opportunity not only to sell but also to enhance the overall brand experience.

Growth and business development
Customer service and quality: the phoenix-like revival of the branch

In the age of online and telephone banking, the branch seems to be making a comeback.

After years of closures, there is a renewed interest in branches, with some of the big five U.K. banks currently in the process of opening new outlets, a trend seen across Europe and the U.S.

Ironically, the commoditization of basic products such as savings, loans and current accounts, and the lower margins resulting from technology-driven cost efficiencies, has actually forced banks to try to cross-sell higher-margin services. These are primarily advice-based, requiring face-to-face discussions best served in a branch. In addition, the profitable small-to-medium-sized business sector tends to prefer using branches for deposits and advice. Consumers have also become disillusioned with the perceived poor service from call centers.

Consolidation has not been as great as expected, with the number of banks falling from 15,000 to 9,000.

Higher-margin services require face-to-face discussions that are best served in a branch.

In addition, retail banks have realized that they are unable to compete with the low-cost Internet-only providers and are using the branch as a means of differentiation.

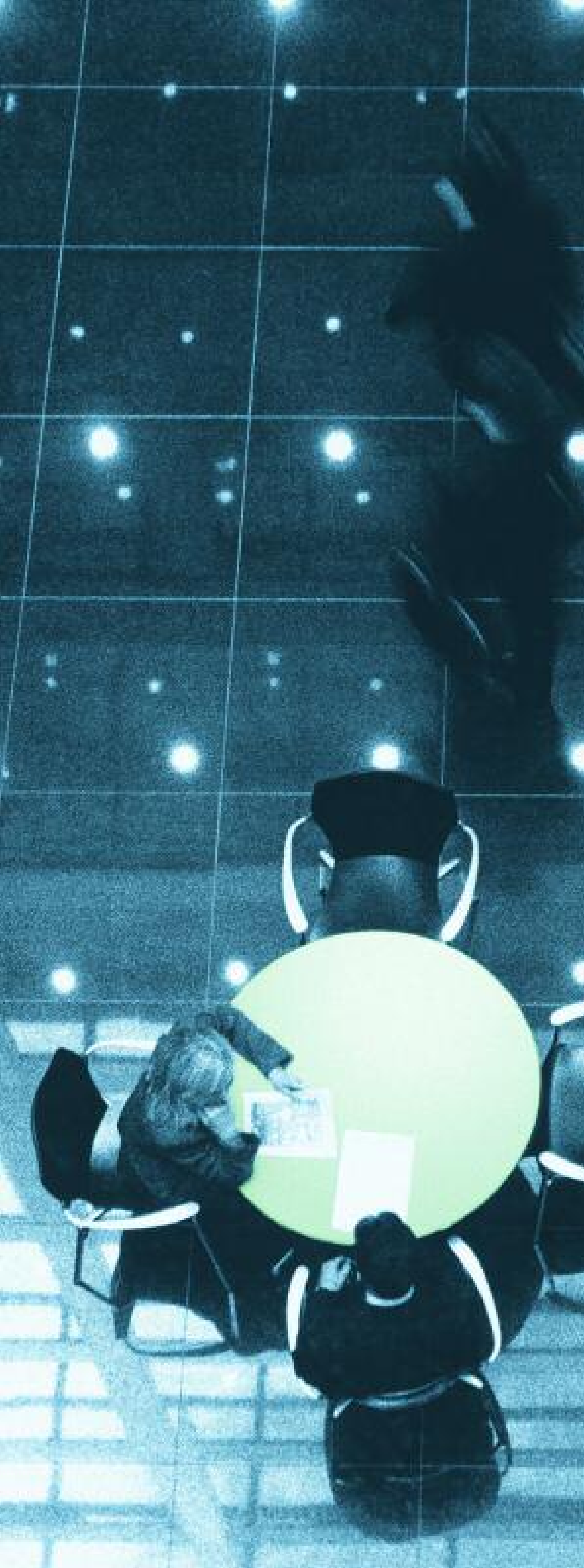
In the quest to give branches more of a 'retail' feel, senior managers have been brought in from other areas of the retail sector. Technology has been extremely helpful, allowing centralization of back office functions, freeing up space in the actual branch for the customer interface. Branches are becoming distinctly more comfortable and friendly, with sofas, TV's and in some cases even drinks. Improved queue management and peak hour staffing has reduced the traditional long lunchtime lines of frustrated customers.

The role of retail staff is also changing. Tellers are not really suited to selling complex products, with the additional problem that this can hold up the queue. Therefore banks are channeling customers via tellers, as well as using 'queue walkers' with hand-held devices, who meet and greet as well as direct people to sales advisers, book meetings or divert customers to ATMs or automated deposit machines.

More aggressive sales techniques have also been employed, including loan sales and loss leading products (such as very high interest for a limited period), as well as added value services including free travel insurance and breakdown cover. Some banks have even piloted the use of home and office sales visits; these may include franchising territories for certain types of product.

For now, reports of the demise of the branch are premature, but its continued success will in part depend upon the ability of staff to effectively sell higher-margin products.

4 Federal Reserve (2005)
5 Federal Trade Commission (July 2004)
6 Wharton (2005)



U.S. – the branch still rules

Despite a proliferation of service providers and channels, the American consumer can't seem to break off its love affair with the local branch.

The U.S. banking system has traditionally been highly regulated, restricting banks to states and even counties. However, the deregulation of the past twenty years, coupled with technological advances, is slowly transforming the landscape, creating a broad spectrum of financial service providers. Overall consolidation has not been as great as expected, with the number of banks falling from 15,000 to 9,000.[4] The branch is even undergoing something of a renaissance, with a number of major banks opening new outlets, plus the emergence of new local banks with a handful of branches.

Culturally, the local business communities, as well as many consumers, still see the branch as a key contact point. Indeed, earlier attempts by banks to drive customers away from branches, such as charging for using a branch, were highly unpopular and quickly reversed. Conversely, multi-channel service provision has taken off, with a wide variety of providers, many from other industries. Indeed, the U.S. pioneered this with companies such as GE and AT&T entering the financial services market in the 1990's.

U.S. banks tend to be advanced in their use of database marketing and customer relationship management, focusing on ever smaller micro-segments to target products and grow their share of wallet. The downside of this is that customers are receiving ever larger amounts of direct mail, as outbound telemarketing is declining, primarily for legal reasons.

Data security and fraud are also high on the agenda, with phishing and hacking a real problem. In 2004 around 12 million people experienced some kind of Internet fraud.[5]

Having pioneered the credit card culture, Americans have now taken to debit cards in a big way. This is partly as a convenient alternative to checks but is also a sign of a more cautious approach to consumer credit.

Interestingly, there are currently only around 15 million online banking customers in the U.S.[6] – far less proportionately than in many European markets. This is further evidence that you can't push consumers into new habits but must wait for them to change at their own pace.

Efficiency and cost management
A holistic approach

Any attempts to reduce cost should fit into a bank's broader business strategy. This is particularly important when considering outsourcing.

Like all businesses, banking is continuously seeking cost efficiencies, with technology being the single greatest enabler. It allows financial services providers to achieve significant economies of scale and produce low-cost models to deliver homogenous products. Some providers have created entirely new business models based around Internet or telephone-only delivery. The excessive cost of call centers makes 'self-service' channels imperative, driving customers to apply for and monitor products via the Internet.

Mergers and acquisitions have the potential to bring in economies, but with the nature of this activity, extreme caution should be exercised. Establishing core merger and acquisition skills within the organization can help in both the choice of new partners/targets and their subsequent integration. Too many banks have indulged in spending sprees only to discover that expected bottom-line improvements failed to materialize.

Devolving decision-making can increase efficiency, particularly when it comes to handling customer complaints. These are typically low-value, yet once escalated can cost the bank thousands of pounds in management time and also upset the customer. It may be economical to have a 'no quibble' policy combined with a fast decision-making process. Linking incentives to efficiency improvements can also help profitability.

Ultimately, every activity should be measured in terms of its contribution to profits. A more rigorous approach to customer acquisition and retention can help banks consider more carefully the cost benefits of acquiring new customers and make them work harder to retain and nurture existing customers. Many banks do not even attempt to woo back customers choosing to close their account – or even ask why they are leaving.

Sourcing – not a panacea

In the quest to improve efficiency, banks should be looking at centralization of functions, shared service centers and external sourcing alternatives such as outsourcing and offshoring. However, these need to be carefully thought through with any sourcing decisions following broader business strategy – not leading it.

In the rush to cut costs, many financial service institutions have discovered that outsourcing is actually expensive and time-consuming, and can have a negative effect upon customer service levels and internal processes – not to mention staff morale. Very few offshore decisions bring savings within the first five years.

As a general rule, a business should only outsource processes that are non-core and that have no real potential for competitive advantage. Once a core competency has been lost it is very hard to recover the skills and knowledge, and in some cases such 'de-skilling' can be contrary to regulatory requirements.

Once the decision to outsource has been made, the search for a suitable partner begins. Shared values and common strategic objectives are a vital component, although it should be noted that the outsourcing partner may have fundamentally different commercial objectives to those of the business looking to outsource, as they are looking

Some providers have created entirely new business models based around Internet or telephone-only delivery.

to maximize income from the relationship. By agreeing clear and comprehensive governance standards and carefully thought-out, flexible contract terms, banks can help relationship management and build sufficient flexibility to cope with the changing demands of business, including renegotiation and termination procedures.

The growing number of regulatory bodies around the world will also place demands on outsourcing, which can lead to penalties for insufficient governance and also duplicate activities, increasing overall costs.

In choosing potential offshoring locations, many banks have gone for India, China and Eastern Europe, but they should also consider locations such as Malaysia, Philippines, Sri Lanka, Africa, and South America, which can offer low-cost and competent alternatives.

Mobile technology

While the early hopes for mobile banking have not been fulfilled, handsets are gradually becoming a significant channel for both payment and marketing. Although Internet connectivity is getting faster, the limitations of handset size mean that a cell phone is not a convenient means of carrying out anything other than simple transactions.

SMS is currently used to pass sales messages to customers, but also presents a great opportunity to make this process two-way, allowing simple payment decisions using a security code. Another growing use is to send text alerts on matters of security, such as someone using a customer's credit card. In general, consumers like such services and are willing to pay for them.

Cell phones also have a role to play in validating the identity of the holder for remote payments, again using SMS. This process can work well for regular low value transactions such as car parks and public transport.

By storing credit card or bank card details in the mobile handset via a chip, 'proximity' payments can be made, with the point of sale terminal recognizing the details. In time they could potentially replace plastic cards altogether. It is possible that at some point the evolution in hand-held devices will make mobile banking a reality, but the restrictions in keyboard size must first be overcome. Overall, mobile banking is unlikely to be a huge revenue generator and will not replace Internet banking, but it is something that customers demand and expect and therefore needs to be integrated into a bank's operations.

Banks should only outsource processes that are non-core and have no real potential for competitive advantage.

Risk and capital management
Managing credit risk

With consumer debt rising, banks need to continue to refine their approach to credit risk in order to reduce losses and meet regulatory demands.

The expansion in consumer credit is a phenomenon seen across both mature and emerging economies alike, to meet housing and broader consumption needs. Increasing competition, in some cases from lower-cost direct providers, is forcing interest rates down and shrinking margins. This, along with a number of new entrants trying to buy market share, has helped fuel a rise in bad debt.

The introduction of Basel II has forced banks to focus more on assessing the risk profile of each debt portfolio, which is designed to help them integrate risk and capital management more closely into product design and strategy thinking.

Credit risk management should ideally be present at every point of the credit cycle: product development; application by customer; account maintenance and collection process. Continuous updating and validating of credit models can help make them more accurate and predictive over time.

Policy manuals play a big role in helping to ensure consistency across the organization. Ideally, credit procedures should be centralized to avoid applicants being rejected in one branch and then approved in another. To try to limit fraud at operational level, procedures should be automated with operations carried out centrally.

Before sharing credit information with credit bureaus, banks should consider the dangers of too many providers getting hold of names and 'over-marketing' to individuals who get offered vast amounts of credit and could end up with substantial bad debts.

Combating operational risk

Operational risk is defined as the risk of loss resulting from inadequate or failed internal processes, people and systems, or from external events. Basel II is highly risk-sensitive when compared to its predecessor, Basel I, and this has led to a greater focus on capital efficiency by investors, which should significantly reduce a bank's overall risk rated assets . Furthermore, regulatory arbitrage – selling off the non-risk-rated parts of a portfolio – is no longer permitted, meaning that risk rated assets should increase.

A further advantage flowing from Basel II is a general improvement in many banks' information systems. In time this should lead to better risk management, less capital being held and greater trust among investors. One key step in establishing an operational risk protocol is to keep a loss database for losses over a certain amount.

In assessing a bank's total capital requirements, it is important to understand the total loss distribution across all the risk segments in the business. It can also be a real challenge to find ways to aggregate different losses and measure the diversification effects between these risks.

Operational risk has a surprisingly broad impact upon strategic decisions, particularly mergers and acquisitions. When approaching a merger or joint venture, a bank needs to spend time assessing and mitigating the operational risks within the target company or partner.

Ultimately, to manage operational risk effectively, business unit managers should be fully responsible for all risks in their area of control. A centralized unit may not have the same degree of understanding or take full ownership of the risks.

Credit risk management should ideally be present at every point of the credit cycle.

Risk and capital management
Fraud – staying one step ahead

The nature of fraud is changing, as are the people who are perpetrating it – and technology is opening up new opportunities for them.

In recent years organized gangs of criminals have emerged, employing increasingly sophisticated methods to attempt – and succeed in – major theft, moving away from their traditional activities such as prostitution or drug dealing.

Financial fraud offers attractive and relatively easy returns, as it usually avoids causing physical harm to individuals, and is often seen as a 'victimless' crime. Police forces tend to focus on detecting and prosecuting more obviously harmful crime. Large fraud cases are also notoriously complex and time-consuming to investigate.

Companies who are victims of fraud often do not pursue the individuals involved or try to recover assets, for fear of damaging their reputation.

Relaxation of border controls within the European Union, and its expansion to include Eastern European countries of the former Soviet Union, are also increasingly significant factors. Criminals can cross borders and escape back to remote locations.

Facing up to the challenge

The sheer scale of the challenge makes fraud prevention and detection a financial imperative for business. Developments in regulation are also imposing pressures, with various measures making it a criminal offence for directors to disregard evidence of financial crime.

Implementing appropriate personnel policies and procedures is an absolutely fundamental first-line defense. There are particular challenges for recruitment; many companies fail to make adequate checks on references and also need to carry out thorough credit checking to spot in advance those who might be susceptible to temptation or to blackmail.

In 2004, a KPMG International survey of fraud cases revealed that 32 percent of financial frauds were perpetrated by trusted employees with 10–25 years' experience in the company, and a further 22 percent by those with 5–10 years' experience. It is essential that companies regularly refresh their credit and risk assessments.

Data-analytics

There are a number of powerful data-analytical tools available to pinpoint vulnerabilities. Some banks are now moving towards more sophisticated model-based techniques that identify unusual patterns of activity to indicate new previously unknown types of fraud. Historical data is also used to build predictive fraud propensity models.

Finally, the right overall control environment is also required across the organization. A key weapon in detection and prevention is the availability of a confidential tip-off or whistle-blowing line, which employees can use to report suspicious behavior in confidence. Many companies are now introducing such mechanisms.

Over half of financial frauds are perpetrated by trusted employees with more than five years' experience in the company.

Keeping you informed

Thought leadership

The KPMG firms' thought leadership library explores the challenges for the financial services sector raised by change in the broader business environment – the economy, the regulatory framework and the forces of globalization. Listed below is a recent selection of KPMG International and KPMG member firms' publications.

Alliances and joint ventures
Banking beyond borders
Banking Insiders: www.kpmginsiders.com
Banking on human rights
Basel II – a closer look: managing operational risk
Basel II – a closer look: managing economic capital
Basel II – a worldwide challenge for the banking business
Basel Briefing series
Branch capital attribution for banks – A survey of international capital
Capturing value from MiFID
China's city commercial banks: opportunity knocks?
Customer satisfaction: at what price?
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Frontiers in finance – Regulation: all risk and no reward?
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Frontiers in finance – Opportunities in a changing market
Frontiers in finance – New markets, new risks, new challenges
Global anti-money laundering survey
Hedge funds: a catalyst reshaping global investment
Hungry for more – Acquisition appetite and strategy in the global private banking and wealth management industry
Hungry for more – Global update
MiFID: The Markets in Financial Instruments Directive
Rethinking the Business Model
Sourcing: Asia Pacific Outsourcing Survey
Sourcing: Voices of Experience – Real Life Experiences with Outsourcing and Offshoring
Sourcing: Future Sourcing – Evaluating the risks and benefits of sourcing
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www.us.kpmg.com/microsite/FSLibraryDotCom/azlisting.htm

Conferences and industry events in 2006

KPMG International and KPMG member firms' hold and support a range of major conferences and industry events around the globe.

June 5 – June 7	KPMG's Global Actuarial Conference	Paris, France
June 6 – June 8	Derivatives and Risk Management Summit	Monte Carlo, Monaco
June 28 – June 29	Global Financial Services Tax Conference	Edinburgh, Scotland
July 4 – July 6	Fund Forum	Monte Carlo, Monaco
July 10 – July 14	Global Alternative Investment Management (GAIM) Conference	Cannes, France

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