

The 2013 Retail Banking Radar

Cold Front Approaching

Recovery remains sluggish for Europe's retail banks. Last year was another difficult year for many institutions, and 2013 is also turning out to be challenging.

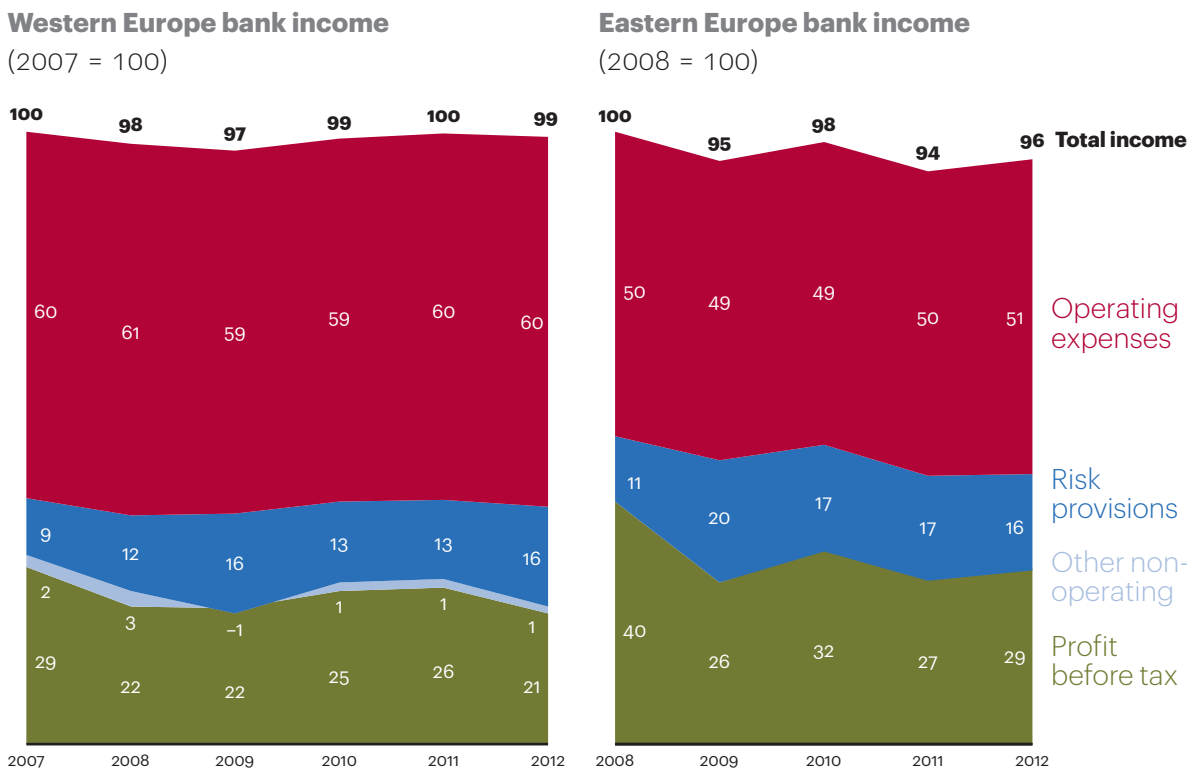


Deposits have surged, fueled by economic uncertainty. Loan growth continued but at a slower pace. With the exception of banks in the countries with the greatest economic difficulties—Portugal, Spain, Italy, Romania, and Hungary—risk provisions are on a downward trend.

But the continued overall economic troubles are weighing on the industry. Total income slightly declined in 2012, and costs remain in flux. Countries where sizable risk provisions have been built up are tackling costs in a particularly aggressive way. For example, retail banks in Portugal had 7 percent lower costs in 2012 year over year; Italy’s UniCredit Group reports having reduced its staff by almost 10,000 full-time employees (almost 25 percent of its head count) during the past four years. However, in Europe, many banks are merely containing costs or even seeing slight increases (see figure 2).

Figure 2

In most of Europe, costs have remained steady or have increased slightly

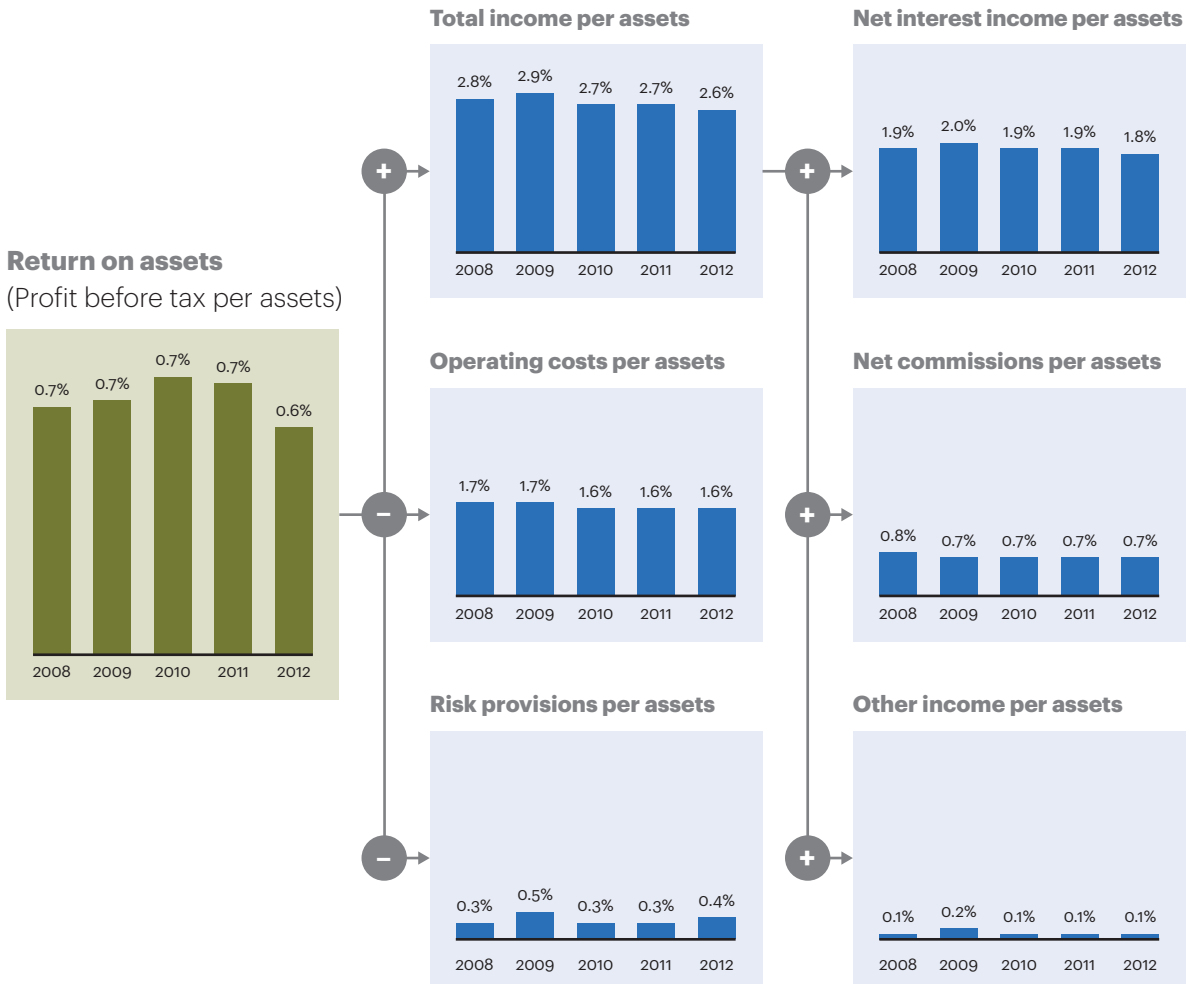


Source: A.T. Kearney analysis

On the whole, European retail banks saw profitability decline in 2012 to the lowest level since the beginning of the financial crisis, with return on assets (RoA) falling from 0.7 percent to a historical low of 0.6 percent (see figure 3 on page 4). This decline is the result of lower net interest margins and higher credit risk provisions driven by the economic crisis in Iberia, even if we exclude Bankia as a clear outlier (see sidebar: Spain: Hit Doubly Hard on page 6). Leaving aside Iberian countries, where many banks recorded negative profits on their domestic operations in 2012, profitability levels in the rest of Europe also declined, but not as dramatically.

Figure 3

Return on assets for Europe’s banking sector dipped because of increased risk provisions



Source: A.T. Kearney analysis

On a regional level, we are witnessing four different realities within Europe: Nordic countries and Switzerland have left the crisis behind them and are already experiencing solid profitability levels. Most Western European countries are suffering from low growth and margin compression, affecting their profitability. The Mediterranean countries (Italy, Spain, and Portugal) saw their risk provisions dramatically increase and are now on an ambitious restructuring route. With a few exceptions, Eastern European countries are slowly getting back to normal and striving to converge gradually with the income per customer levels that exist in other European regions.

These are among the main findings of the A.T. Kearney 2013 Retail Banking Radar, an annual index that monitors the dynamics of Europe’s retail banking sector (see sidebar: About the Study on page 8). This year’s findings point to increasing volatility and more difficulty ahead. Although different European banks are diverging in terms of performance, there is no “safe house.” Depending on a country’s economic prospects and individual institutions’ financial strength, the best actions range from strict cost scrutiny to increased focus on non-performing

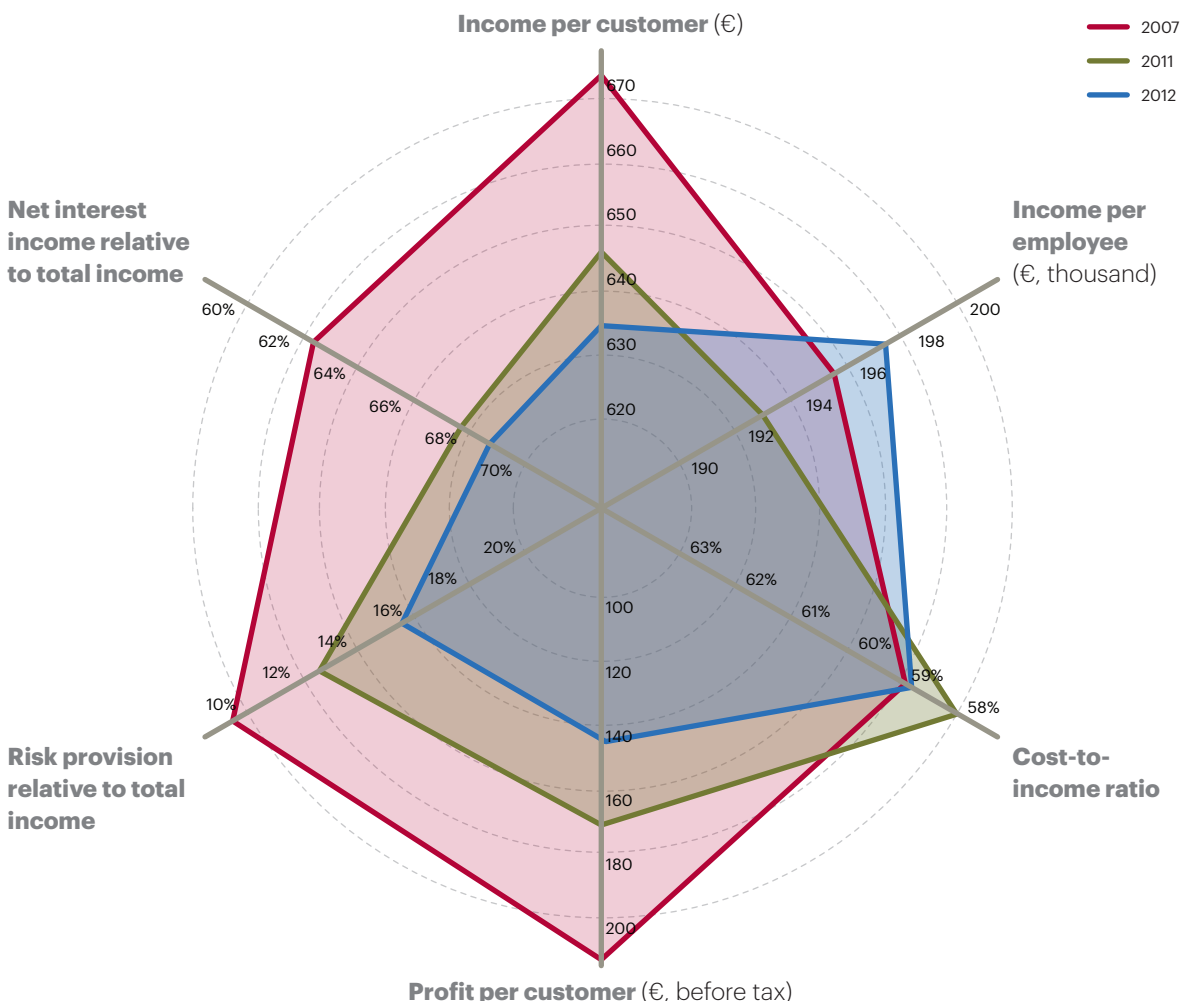
loans to channel innovation. The crucial question is whether these actions are sufficient to improve profitability and at least partially move banks back to pre-crisis levels of return.

This paper begins by examining the state of Europe’s retail banking industry and identifies some of the primary regional differences. With an understanding that challenges and opportunities never lie far apart, we discuss our expectations about the future of the industry, including pending structural changes, evolving client preferences, and untapped opportunities.

The Past: A Mix of Clouds and Sun

To understand Europe’s retail banking industry today and get a glimpse into its probable future, it is first instructive to examine the market’s development since 2007. Six indicators, as shown in figure 4, are important because they highlight several key factors in the industry, including the ability to realize customer potential, balances in sources of income, employee productivity

Figure 4
The evolution of Europe’s retail banking industry, 2007-2012



Source: A.T. Kearney analysis

Spain: Hit Doubly Hard

Spanish banks have been hit hard both by the financial crisis and the country's real-estate bubble burst. This has been especially relevant considering that, by the end of 2011, almost 60 percent of the Spanish financial industry's loan portfolio to the private sector—up to €1 trillion—was associated with real estate (construction companies, real-estate developers, and individual mortgages). As a result, the non-performing loans ratio had grown from 0.9 percent in December 2007 to 7.6 percent by December 2011.

The government and the Bank of Spain reacted, launching new regulations to tackle the issues with the real-estate loan portfolio, forcing new provisions and capital buffers to Spanish banks that added up to €82 billion to be covered between 2012 and 2013.

In addition, several stress tests of the financial sector were conducted in coordination with EU authorities, leading to a detailed stress test that identified the potential capital shortfall of Spanish banks in different scenarios. The results have been used to classify the banks into four groups, with specific road maps associated to solve their capital and loan portfolio issues, and with part of them receiving public aid from Spanish and European authorities.

The banks that received public aid have also been forced to transfer their problematic real-estate assets (both loans and physical assets) to a new public “bad bank” called Sareb, assuming a haircut on the transfer price of those assets. This transfer, together with tighter criteria to classify their loan portfolio, has led to

dramatic losses on those banks with government participation. The most important case was Bankia, which alone assumed almost €20 billion in provisions and losses on its loan portfolio in 2012, and for this reason was not included in the 2013 European Retail Banking Radar, as it represented a one-off outlier.

In 2013 and 2014, new stress tests will be conducted to ensure the viability of the Spanish financial sector, while Sareb conducts the ordered disposal of more than €50 billion in problematic assets from the nine banks with public intervention.

levels, cost base management, and credit quality. Although there has been improvement in some places, on the whole, European retail banks' performance slipped in five of the six indicators.

Income per customer. After a post-crisis rebound, income per customer declined in 2012 to €635. The decline, a natural result of an overall drop in retail banking in 2012, was not as steep as in 2009. Only a few markets withstood this trend, namely the Nordic countries and Benelux, because of generally higher price levels and stronger economies. Iberia and France saw the most sizable declines, of more than 5 percent.

Income per employee. Income per employee was one of the few indicators in which Europe improved in 2012. At €196,500 per employee, productivity exceeded 2007's level of €195,300. The increase clearly indicates that one cost-reduction measure has been head count, although unlike past years, retail banks seem to have gone beyond the pure “haircut” and have made an extra effort to identify and nurture better performers.

Net interest income relative to total income. Net interest income relative to total income increased in 2012, accounting for close to 69 percent, up from 63 percent in 2007. In select regions, such as Benelux and the United Kingdom, net interest income has risen well above 75 percent of total income. Low interest rates and sluggish demand for loans cap the growth potential and keep interest income flat in absolute terms. A decline in commission income,

however—especially commissions from investment products and, in some countries, such as France, from life insurance—has provided proportionally more weight to net interest income.

Cost-to-income ratio. On the surface, it appears that banks have done little to improve operational efficiency. The cost-to-income ratio oscillated over the last five years in a very narrow band between 58 and 59 percent, and 2012 happens to be on the higher (less favorable) side of this scale. Yet, the story behind these numbers varies widely from market to market. In the Nordic countries, higher revenues balance a cost-base increase. In Portugal, on the other hand, banks reduced costs by as much as 7 percent but still did not see their efficiency increase because of sharp income declines (see sidebar: Portugal: Sharp Income Losses).

The overall stability in cost-to-income ratios indicates that banks have effectively managed costs in line with expectations about income development. But it also shows that many have shied away from more fundamental redesigns of their business and operating models—they have not yet prepared for the higher levels of risk and equity requirements that await.

Risk provisions relative to total income. After peaking in 2009, risk provisions seemed to stabilize and even decline. However, loan impairments surged again in 2012 to more than 16 percent of total income, driven in particular by significant new provisioning for banks in Iberia and Italy. Provision levels also grew in some Eastern European countries, reaching more than 30 percent in both Hungary and Romania.

Portugal: Sharp Income Losses

In 2012, the net interest income of major Portuguese banks' domestic retail banking activity dropped below half of pre-2008 levels. This was caused by several factors, namely a reduction in bank lending, low profitability in mortgage loans portfolios, historically low levels of short-term interest rates, and high funding costs. The downward pressure on net interest income together with the recognition of impairments in the credit portfolio amid a deteriorating macroeconomic outlook are putting major pressure on the profitability of Portugal's retail banking sector.

First of all, to adjust their balance sheets for a more sustainable financing structure, banks have been forced to undergo a process of deleveraging. With a target loan-to-deposits ratio for major banks of 120 percent following the Portuguese bailout, the

deleveraging has cut bank lending volumes by 12 percent since 2010 and simultaneously increased deposits.

In addition to this volume effect, a substantial decline in the average spread between interest on lending and borrowing emerged. In particular, this has been the case for existing mortgage loans, which represent a very large proportion of Portuguese retail banks' credit portfolios—more than 80 percent of total household portfolios for several major banks. Most of those loans, often with maturities of more than 30 years, were contracted over the past decade with extremely low, fixed spreads compared to banks' current funding costs. Additionally, the reduction of interbank interest rates to historical lows considerably compressed the margin of sight deposits upon which no interest is paid.

In parallel, banks' high funding costs resulted from the increase in deposit interest rates and from the high interest rates paid by rescued banks on hybrid instruments such as the "CoCo" bonds that Portugal's government used to capitalize banks in the first half of 2012. In terms of deposits, the intense competition and high interest rates for new deposits even obliged the Bank of Portugal to take some prudential measures at end of 2011. Last year, increased funding costs were aggravated by a reduction in Portuguese banks' exposure to low-cost funding by the European Central Bank in the second half of the year, and by some banks' high-cost debt issuances during the last quarter.

Leaving out the Mediterranean countries, the provisioning level in the rest of Western Europe came down significantly and is now around the normal pre-crisis provision level of approximately 9 percent. In Eastern Europe, the decline was also sizable in the last three years, and the provisioning level is currently at 18 percent. Still, it is too early to declare victory in these countries. Further deterioration in the economic environment across Europe and exchange-rate fluctuations in Eastern Europe may bring a new wave of repayment difficulties and defaults. So caution and continued elevated provision levels remain advisable.

Profit per customer. High provision levels have put pressure on overall profitability. Client profitability declined by more than 30 percent compared to 2007 and by 16 percent compared to 2011. While the Mediterranean and some Eastern European countries have been the sources of this trend, the big picture is that the crisis times are not over yet. Threats to profitability still lurk in some portfolios and can quickly materialize if the economic situation worsens.

About the Study

The 2013 European Retail Banking Radar tracks 93 retail banks and retail banking divisions in 24 European markets. Forty-five banks are in 13 European markets we have analyzed in past editions of the Radar—Austria, Belgium, Denmark, France, Germany, Italy, the Netherlands, Norway, Portugal, Spain, Sweden, Switzerland, and the United Kingdom. (The Nordic and Benelux markets are clustered to obtain a meaningful regional sample.) This year, for the first time, we also track 11 retail banking markets covering 48 banks in Eastern Europe: Bosnia and Herzegovina, Bulgaria, Croatia, Czech Republic, Hungary, Poland, Romania, Serbia, Slovakia, Slovenia, and Turkey. Central Eastern Europe covers the Czech Republic, Hungary, Slovakia, and Slovenia; South Eastern Europe includes Bulgaria, Bosnia and Herzegovina, Croatia, Romania, and Serbia; Poland and Turkey are tracked on their own because of size.

We estimate that we cover more than half of the retail banking market in the markets we analyze; in some countries with high

banking concentration, it rises to 80 percent. The study includes close to 530 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 uses official bank records and covers the period January 2007 through December 2012. The reports 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.

Definitions:

Customers refer to retail banking customers counted by the bank, not account numbers or relationships. 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, A.T. Kearney makes estimates at the segment level.

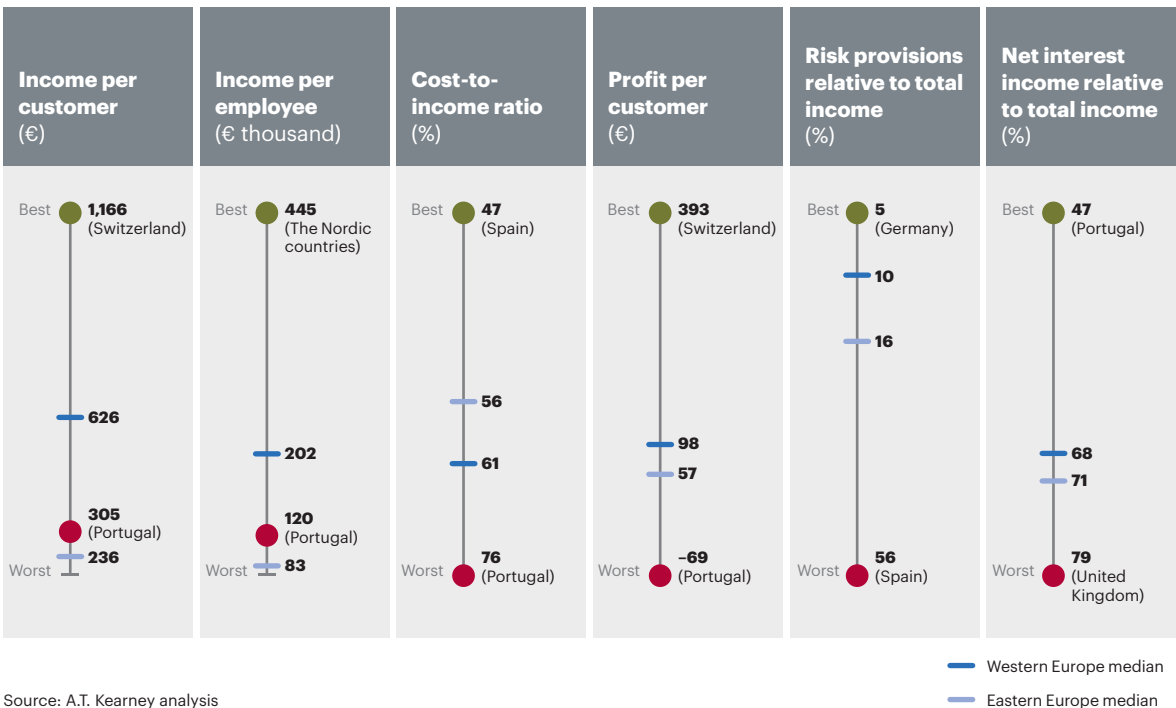
Income refers to net banking income, including net interest income, net commission income, net trading, and other income.

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

Divergent Europe

Last year brought a mix of clouds and sun for European retail banks, and different parts of the continent experienced different developments. The most important trend in 2012 was a widening of the gap between the best- and worst-performing countries (see figure 5). In 2011, income per employee ranged in Western Europe between €124,000 and €393,000; in 2012, it ranged from €120,000 in Portugal to €445,000 in the Nordic countries. Similarly, the maximum level of risk provisions expanded from 36 percent of income in 2011 to 56 percent in 2012. Retail banks are increasingly diverging in performance because of structural weaknesses that have been amplified by the local economic cycle.

Figure 5
How some Western European countries compare on the key indicators



Source: A.T. Kearney analysis

Following is a look at the regional differences in terms of performance.

The top of the range: the Nordics and Switzerland. Retail banks in the Nordic countries and Switzerland rank historically high along multiple dimensions of performance. Swiss banks have long excelled in income per customer, which, coupled with a relative improvement in their cost position, gives them highest profits per customer of all banks in our sample. Nordic retail banks boast superb productivity fueled by high income per employee and disciplined cost approach. Nordic banks’ low cost-to-income ratio—the second lowest in 2012 after Spain—is a result not only of traditional cost reduction measures, such as back-office centralization and continuous improvement, but also their trend of downscaling branch networks and skillfully deploying technology in communication to clients.

Facing turbulence: Italy, Spain, and Portugal. Retail banks in the Mediterranean countries faced a turbulent year shaped by the uncertain economy. A housing market collapse and rising unemployment led to an unprecedented increase in loan provisions in these countries (see figure 6). Despite far-reaching structural measures aimed at cost cutting—for example, the closing of hundreds of branches—profitability has plunged to historical lows, with banks in Spain and Portugal making a loss with every client they serve. Still, Spanish banks managed to keep their leadership in cost efficiency, which will surely be an important factor in their recovery.

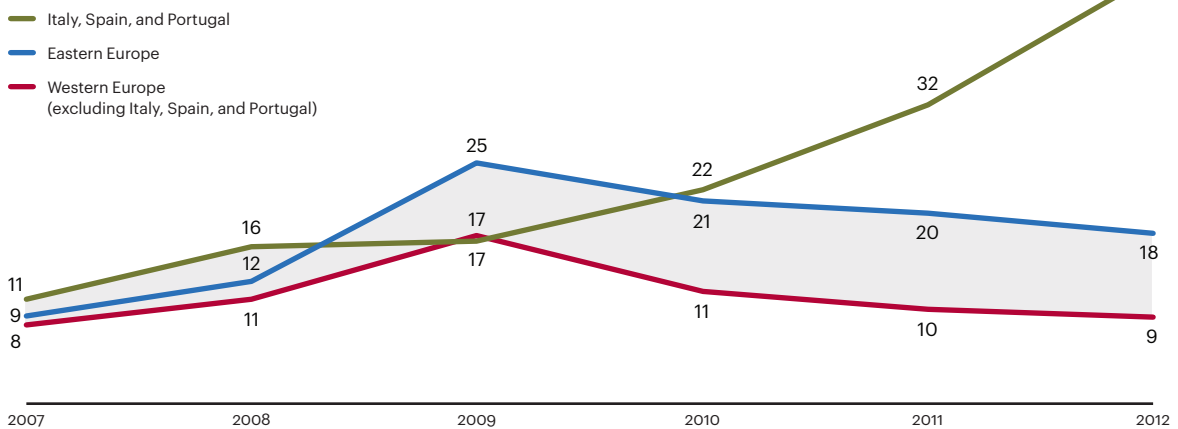
Sluggish recovery: Western Europe. The remaining Western European countries went through another year of almost flat growth and margin compression. Net interest income remained flat, with contractions in all countries except the United Kingdom. The engine of past profitability—investment products—is still slow to recover in terms of both volumes and margins. Funds have shifted away from higher risk and higher return asset classes, and investor confidence is difficult to recoup. Intensive competition across the region perpetuated waves of cost improvement during the past 10 years. Although it is unlikely that there is no further potential for cost reduction, it is certainly fair to say this potential is smaller than in other regions of the continent.

Figure 6

Economic conditions led to unprecedented loan provisions in Italy, Spain, and Portugal

Risk provisions relative to total income

(%)



Source: A.T. Kearney analysis

Potential for growth: Eastern Europe. While Eastern Europe was a profit engine within multiple banking groups before 2008, margins have come down significantly. Within Eastern Europe itself, there have been sunnier spots—such as Poland, the Czech Republic, and Turkey (see sidebar: Turkey: Exceptional Growth on page 11)—as well as countries experiencing difficulties similar to Iberia, particularly Romania, Slovenia, and Hungary. While it is difficult to generalize about so many countries under the geographic umbrella of Eastern Europe, there is one common trait: All still lag behind the West European levels of penetration of loans, deposits, and investments. While the difficult economic environment is amplified locally because of the small size of most

Turkey: Exceptional Growth

Turkey's banking industry has grown 16 percent yearly since 2008-2009, helping it become a showcase for growth across Europe.

Following a collapse in the early 2000s, Turkey's banking sector has undergone fundamental reform and restructuring and has been transformed thanks to innovation, particularly in retail and small and medium-sized business banking, digital channels, and payment systems. As such, the industry was both an engine for growth over the past decade and one of the primary beneficiaries.

In 2012, the banking industry growth slowed to 12 percent, mainly due to monetary policies aimed at preventing overheating of the economy. Combined with negative global outlook, this led to weaker domestic demand and restricted growth. In 2013, the sector is expected to grow in line with an anticipated revival in private consumption and investment expenditures, supported by historically low levels of interest rates.

Going forward, Turkish banking will present significant potential because of the country's young population, low household debt

level, unbanked segments, and transformation into a formal economy. It will also need to tackle several challenges: the threat of non-banking payment service providers, regulatory pressures on fee income, increasing direct access to capital markets, and the saturation of some banking services.

countries and their strong dependency on export to European Union (EU) partners, there is clear potential for growth in the region in the mid-term and gradual conversion of client income and profitability to levels similar to Western European banks.

Looking Ahead: Turbulent Weather

Understanding the future of retail banking in Europe starts with understanding the economic environment and changing customer behavior. And the conditions today are indeed difficult. The latest Eurostat forecast expects a continued slowdown in economic growth in 2013 compared to 2012 across Europe. Specifically, 12 EU27 countries, including Germany and France, will see lower GDP growth. Unemployment is projected to rise to a new high of 11.2 percent in 2013, while real disposable income is expected to decline in 10 countries, according to the Economist Intelligence Unit (EIU). Preliminary forecasts for 2014 are brighter but still bear a high level of uncertainty (see figure 7 on page 12).

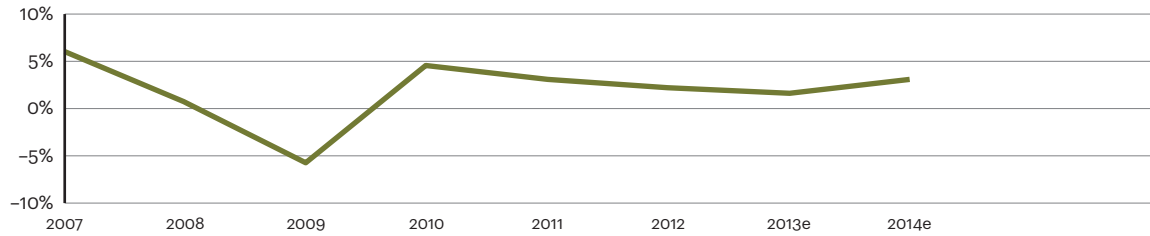
It is only natural that the difficult economic forecasts are impacting consumer attitudes and preferences for financial products. As a result, several themes will dominate retail banking in 2013:

A real estate lull. According to European Central Bank data, the average European is delaying investment decisions related to property purchases and renovations. More have put their personal disposable income into savings for the uncertain times ahead, and we do not expect this trend to change except in markets, such as Germany, Switzerland, and Austria, where real estate prices did not decline during the crisis and where property has served as an alternative to capital market products for funds looking for mid-term secure returns.

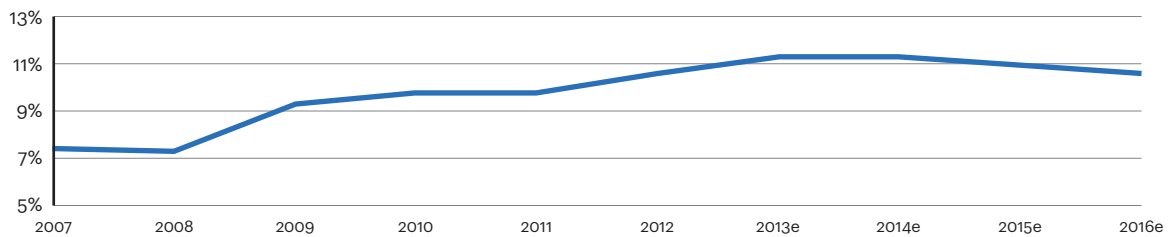
In 2013, we expect mortgage volumes to grow on average at the same pace as the economy. This means portfolios will not be fully replenished in some countries, while slight growth is

Figure 7
Understanding today's difficult economic conditions

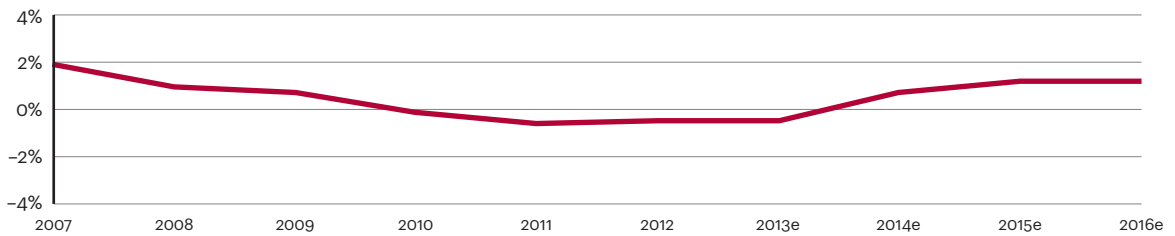
Nominal GDP growth rates



Unemployment rate in the EU27



Change to real personal disposable income per year



Source: Eurostat

possible in others. Margins are likely to remain at the current low levels unless contract flexibility allows for across-the-board re-pricing. More sizable improvement may come in 2014 and beyond, thanks to structural factors such as limited real estate stock in large cities, smaller families, more frequent relocations, and demand for higher living standards.

After five years of limited activity, first-time home buyers and home owners with renovation plans will at some point begin slowly venturing into the market. However, when this happens and to what extent will depend on the strength of the economic cycle.

Short-term savings. Savings rates in Europe have increased since 2008 and will likely remain high as a cushion against economic uncertainty. In most markets, we expect deposits to increase in 2013. This means further improvement in loan-to-deposit ratios and additional relief for many institutions' funding situation. Customers will likely still prefer short-term maturities and value flexibility in accessing their own funds, particularly in the crisis countries and developing markets in Eastern Europe. Given the current low interest rates and government-imposed restrictions

in some places (such as Spain and Portugal) to avoid a deposit war, margins will remain low but will not erode retail banks' profitability.

Banks in a few select markets will face particular challenges, however, as increased savings rates there do not necessarily translate into higher deposits. While the average Greek citizen held about €400 in cash in 2007, this increased to almost €2,000 at the beginning of 2012; in other countries, such as Slovenia and Hungary, cash holdings increased by as much as 40 percent. This phenomenon has much to do with customers' confidence both in the entire banking system and in individual institutions. Turbulent times can generate sizable shifts of money—and clients—between individual institutions. Retail banks operating in these markets face the challenge of keeping their clients, but they also have a unique opportunity to grab a larger market share. Strengthening client relationships here will play a larger role than pure price offers.

Warming up to capital markets. The share of personal assets invested in equities and investment funds has declined sharply, from 13 percent of personal financial assets in 2007 to 9.5 percent in 2012. Even as the capital markets have recovered—the Dow Jones, FTSE, and DAX are above pre-crisis levels—and investment values have rebounded, the attitude among investors remains reserved. “Greed,” which was named a key driver of investment behavior in the past, is no longer sufficient to bring a rapid increase in clients—many have been frightened off by the two dramatic capital market downturns of the past decade.

A look to the future points to uncertain times ahead—through 2013 and likely into 2014—as consumer trust recovers more slowly than economic indicators.

We do not expect 2013 to bring a large turnaround, except potentially in markets with an established investment culture, such as the United Kingdom and the Nordics. Over the next two to three years, however, a gradual and mild improvement of the capital markets will take place. Some of the cash and liquidity currently in savings or term deposits will flow back into investment (or commission) products. The challenge for retail banks will be lowering price and revenue levels compared to pre-crisis times. In this sense, investment products are likely to add to the revenue-generation issues rather than alleviate them.

Increasingly for retail banks, the challenge will be to innovate in order to provide suitable investment solutions to clients. Products offering a return beyond the long-term inflation level—which current deposit and life insurance products cannot provide—will be key. We believe there are opportunities for new solutions for which customers will be willing to pay a fair margin. Examples include (but are not limited to) crowdfunding offers, the packaging of inflation-indexed loans, and sustainability investments.

More payments. Retail payments remain one of the most crisis-resistant products. Regardless of economic conditions, when rent, utilities, and household purchases are due, they must be paid. The difficult economy has impacted the pattern of payments, however, with larger payments

today often broken down into smaller pieces. While value per transaction is dropping slightly, the overall number of transactions is rising. This increase could generate an important revenue growth area for European retail banks, as we expect this revenue pool to double till 2020.

For retail banks, the primary value of payments comes from being a “frequency generator.” Channeling a larger number of payments through one bank can increase client loyalty and offer opportunity for cross-selling. Chances for strengthening client loyalty emerge in offering of online banking-enabled payments and in the use of mobile and contactless solutions. Additional opportunities for revenue are feasible in alternative payments, where margins are higher than in the traditional branch-based payments.¹

A look to the future points to uncertain times ahead—through 2013 and likely into 2014—as consumer trust recovers more slowly than economic indicators. In best cases, retail banking incomes will stagnate in the next three to five years while provisions, which have already dropped, are unlikely to provide significant additional relief. Cost pressures will increase and with them the need to consider more substantial cost-containment measures. Innovation requires investments that will take years to pay off. New European and local regulations—for example, considerations to raise financial transaction taxes or to extend the national bank levy in Austria—can further affect bank financials. Therefore, we expect bank profitability to decline again in 2013, reaching less than 75 percent of pre-crisis levels.

Before the Cold Front Arrives

Challenges and opportunities are closely linked. There is a continuing need to be wary of market developments and stresses and to capitalize on untapped opportunities. How can banks be ready for this year’s difficult market environment and build a solid foundation for growth if recovery arrives in late 2014?

Get back to basics on the product side. Three product areas will remain crucial for bank profitability in the mid to long term: accounts, mortgages, and investments (and likely in this order of recovery and priority for the banks). With current accounts, price has become increasingly opaque, and “free” is no longer the best tool to acquire new customers. Differentiation comes from value-added services, tailored to a specific client segment and priced appropriately. Despite short-term setbacks, mortgages will rebound, and success will hinge on identifying financing needs early on, for example when a prospective buyer is searching for properties. Investments are the only area where there is a clear call for innovation and multiple starting points, including inflation and interest-rate protection and access to investment categories otherwise unattainable for retail clients.

Continue operational excellence. Cost thinking needs to branch out beyond pure head count or opex reductions. While most European retail banks have gone through rounds of centralization, straight-through processing, and process optimization, keeping operations lean requires continued focus and persistence. Instituting processes and mechanisms to monitor and drive continuous improvement will ensure cost containment. In addition to traditional cost-reduction methods, we see the need for more structural medium-term changes, such as reconsidering branch formats and footprints, co-location models, and multichannel offerings.

Clean up loan portfolios. Most banks have already obtained full transparency of the existing and potential risks in their portfolios and have reflected those in provisions. Vintage curves have

¹ For more about payments, see *Winning the Growth Challenge in Payments* at www.atkearney.com.

started to come down driven by more rigorous risk policies. The challenge going forward—particularly in the Mediterranean countries—will be handling the risks within existing portfolios by keeping an eye on early warning signs, strengthening collections and workout, and selling parts of existing portfolios. This will require more focus and resources along key risk processes.

One vital question remains unanswered: Are these measures sufficient to provide a profitability rebound in the next three to five years? Do they go far enough to bridge the existing profitability gap and potential new declines caused by the economic environment and pending regulation?

Medium- and Long-Term Challenges

While the short-term tactical measures described above can secure brief relief, they are unlikely to suffice in the medium term. Structural changes will be required, particularly in the Mediterranean and selected Southeastern European countries, but also in France, Belgium, and the Netherlands.

We anticipate several developments:

The role of the branch will change. The role of the branch will fundamentally change in the years to come—from owner of the client relationships and center of bank distribution and operations to merely one of many channels in a multichannel world in which the client chooses how to interact. This change will impact branch numbers, size, and formats, likely leading to fewer branches, smaller branches, and a leaner service offering. Different branch formats are likely to evolve depending on geography and client profiles, meaning that one bank will be managing several different types of “networks” in parallel.

The role of the branch will change—from owner of client relationships and center of operations to merely one of many channels in a world where the client chooses how to interact.

The focus of provided services will shift to strengthening client advisory capabilities. As client advisors account for more than half of retail banks’ P&L, new ways to offer high (unchanged) advisory quality at a lower cost will be critical. Innovation—for example the use of remote and video advisory—will make a step forward. The prerequisite for new formats will be finding an effective way to move clients to mobile payments. This is a fundamental change for all banks, a journey that will continue over the next decade.

Service differentiation is becoming more important. While retail banking is by definition about the mass market, in many countries the average retail client is often marginally profitable at best. This is not a new phenomenon, but the situation has deteriorated during the current crisis. The key is determining which clients to focus on serving actively and which ones to transition to remote channels, such as the Internet. Clearly, it will be crucial to nurture relationships with high-value customers while containing or reducing interaction costs with lower-value

customers. This will require understanding not only current client profitability but also their future potential based on demographic, occupational, and psychographic characteristics (based on data mining). This will lead to new types of segmentation.

We expect more differentiated service models to emerge as the basis for serving different high-potential segments, including affluent clients, small entrepreneurs, older women with family inheritances, young professionals, and digital natives. As the range of possible segments grows, retail banks will have to decide where to focus and determine how to succeed. We expect to see a number of specialized players emerge—focused on individual high-profile segments through tailored value propositions—and challenge mainstream banks. The trick for retail banks will be to select the “right” focus segments, create a compelling reason for premium pricing in the segment, and resist overinvesting in a selected segment.

Factories and industrywide utilities. Most banks have already gone through rounds of centralization and standardization in payments, mortgages, and consumer loan operations. While those brought some cost reduction, the scale of some institutions often limits the amount of possible savings. Although consolidation within some countries might still increase and the development of larger pan-European banks will also continue, we do not expect large-scale change over the next five years.

We believe the pressure to significantly reduce costs will revive the need for back-office factories and utilities that bundle volumes for different service models (and even different banks) into a common operating platform. This will require a modular structure for product and service offerings within individual segments to increase processing efficiency. Processing will require flexible and lean human resources structures, state-of-the-art technology, and agreed service levels so that back-office factories and utilities can prove more efficient than banks’ current structures.

Bracing for the Future

For retail banks, 2013 will become one of the more difficult years. While pockets of relief will arise and slight growth could come to several markets, parts of Europe are still struggling, even after several years of changes. The banks that persist in understanding their clients, strengthening their sales engines, improving their structures, and embracing innovation will reemerge stronger after the cold front passes.

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	Berlin	Kiev	Paris
	Brussels	Lisbon	Prague
	Bucharest	Ljubljana	Rome
	Budapest	London	Stockholm
	Copenhagen	Madrid	Stuttgart
	Düsseldorf	Milan	Vienna
	Frankfurt	Moscow	Warsaw
	Helsinki	Munich	Zurich
	Middle East and Africa	Abu Dhabi	Johannesburg
Dubai		Manama	

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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.
