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Financial Services

Global Banking Industry Outlook

*Growth Solutions in a
Changing World*

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Dear Colleague:

For the past eight years, the Financial Services practice of the member firms of Deloitte Touche Tohmatsu (DTT member firms) has produced the annual Banking Industry Outlook to address the “top 10” issues affecting firms in the year ahead. This year, we took a new approach, working with the Economist Intelligence Unit to develop both a long-term industry view, entitled *Global Financial Services Industry Outlook: Shaping Your Strategy in a Changing World*, as well as companion reports that consider these same issues at a more focused level by sector.

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Our *Global Banking Industry Outlook: Growth Solutions in a Changing World* report finds that while issues like risk management and regulatory compliance remain a challenge, there are a number of opportunities for growth – particularly through globalization and expansion into new markets, innovative technologies to improve service delivery for the customer and new investment products to meet the needs of retiring baby-boomers.

To identify critical market drivers for our *Global Industry Outlook* reports, we conducted an online survey of 175 board members and global executives across the financial services industry, of which 50 were from the banking industry. Based on our findings and our client experiences, we believe that the issues identified within this report will have the greatest impact on banks as they approach 2010. Retail and commercial banks, thrifts, credit unions, mortgage banks, foreign banks, credit card companies and finance companies should embrace the imperatives outlined in this report to achieve long-term success.

We plan on continuing our research into the future of the banking industry and examining other ways in which banks can sustain growth in a changing and dynamic world. In the meantime, we hope you find this report valuable.

José-Luis Garcia
Global Banking Leader
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Flush with cash and capital, banks are positioning themselves to succeed in the future. The precise details have yet to be filled in, but the challenges are clear today. Banks must cope with new markets, demanding customers, the quest for efficiency, and the need to control reputational and operational risks. Major banks have begun the process of reinventing themselves to deal with these issues and others.

Despite the number of challenges facing the industry, opportunities for growth are plentiful – particularly through expansion in new markets, technology and personalization to enhance customer relationships and new products and advisory services to meet the needs of retiring baby-boomers. In this paper, we focus on the five most important issues over the next three to five years as revealed through an industry survey, interviews with senior executives and practice leaders from the DDT member firms. The five top issues on the banking watch list are:

- **Globalize and consolidate.** Spurred by falling cross-border investment barriers, banks will expand abroad by acquiring or merging with banks in other countries. Banks are moving away from traditional outsourcing toward captive operations or a mix of captive and outsourced functions. China will be a critical market, but presents geopolitical risks and structural market challenges.
- **Reconnect with the customer.** Slow growth in existing markets will push banks to reconnect with customers through a combination of state-of-the-art technology and personal service.
- **Promote compliance.** In an increasingly strict regulatory environment, banks must adopt a principles-driven approach to policies, standards and systems to ensure compliance.
- **Better manage risk.** Banks now view operational and reputational risk to be greater concerns than market, credit and liquidity risk. Data privacy and security have become hot-button issues and will remain so for the foreseeable future.
- **Adapt to demographic shifts.** An aging population will continue to drive the development of banking products and services targeted to older customers.

Mixed expectations on margins

Survey respondents (board members, C-level officers, business unit heads and other senior executives) offered a mixed picture on the economics of the banking industry. Nearly a quarter of all banking industry respondents expect costs to grow faster than revenues over the next three to five years. Approximately a third of respondents expect cost and revenues to grow at about the same rate, while 43% of respondents expect revenues to grow faster than costs.

Why the mixed bag? Among the trends cited by survey participants are:

- While industry consolidation and cross-border mergers will result in economies of scale, more efficient delivery and the ability to participate in the faster growth of emerging economies, banking organizations will continue to struggle with the challenges of managing global organizations.
- The expansion of offshoring, which will enhance efficiency.
- Compliance costs will continue to be a drag on earnings.
- Rising interest rates and a flattening yield curve will depress margins, especially in the United States.
- The banking industry is coming off of years of record profits. Growth may be slow, but it is starting off of a high base.

The five issues to watch

1. Globalize and consolidate

Crumbling cross-border investment barriers have presented large banks with the opportunity to expand abroad relatively freely by acquiring or merging with banks in other countries.

Many national markets are already dominated by a handful of large banks. New growth will come from cross-border expansion into both developed and emerging markets. Global banks may realize significant economies of scale from their size and geographic spread, but local and regional institutions will remain powerful competitors in many markets.

A wave of European cross-border banking mergers is finally at hand. The scale could mirror the consolidation of the US market in the 1990s. By 2010, hundreds of banks could disappear and a handful of pan-European players emerge, according to a recent Deloitte Research report, *A New Playing Field: Creating Global Champions*. Survey respondents see cross-border consolidation as an important aspect of globalization over the next three to five years, with 45% citing this trend.

The political and regulatory obstacles to European mergers are falling. The European Union opposes regulatory obstacles to cross-border deals, UK and German regulators have raised no objections to recent deals and some European courts have opposed discriminatory tax treatment of cross-border entities.

Cultural barriers are on the wane. Huge price discrepancies for banking services across Europe have created a climate ripe for more competition. The average Italian retail customer, for example, pays 250 euros a year for banking services, compared to

30-60 euros for the same services in the UK and the Netherlands, according to a recent YouGov study. That study, of 2,300 European retail banking customers, found 68% willing to buy products from pan-European firms.

Banks that have already squeezed excess costs from their operations are chasing double-digit growth in over-banked domestic markets. Acquisition offers a way to gain entry to more attractive markets, put excess capital to work, justify high stock prices and achieve further operating efficiencies. Through its \$19 billion HypoVereinsbank acquisition in 2005, for example, UniCredito gains a branch network in Central and Eastern Europe, fertile markets for traditional banking products such as credit, and expects to realize cost savings from headcount reduction and operating synergies.

Offshoring

Even more important than global consolidation over the next three years will be offshoring. Nearly 47% of our banking industry survey respondents say the trend will be a top profit driver. A Deloitte Research report, *Global Financial Services Offshoring: Scaling the Heights*, estimates that offshoring generates savings of \$5 billion a year for financial firms, more than 40% on the cost of running the same operations onshore. Expanding the commitment further would substantially increase savings, the report found.

Banks increasingly are moving away from outsourcing toward captive operations or a mix of captive and outsourced functions. HSBC, for instance, has expanded offshoring beyond basic processing into research and IT development and has only captive operations, building up operational sectors in India, Malaysia, the Philippines, Sri Lanka and China.

Offshoring does present challenges. For example, banks in Europe, where 35 languages are spoken, have more trouble finding offshore sites than US banks. To succeed at offshoring, banks must manage four key elements: complexity, compliance, culture and cost. Banks should streamline processes before relocating them.

China

Nearly two-thirds of banking survey respondents say that China will be important or very important to their organization in 2010, compared with 44% for India, nearly a third for Russia and just 22% for Brazil. The focus on China isn't surprising given that China not only has the world's largest population, but also one of its largest savings rates – 40% of GDP.

Yet despite the stampede to invest in China, the vast majority of investments there are in the red. On the one hand, establishing a presence early may be critical to succeeding in China. On the other, the risks of rushing into a risky environment may outweigh the benefits.

Fortunately, China's political leaders appear to have an iron commitment to bank reform – a commitment backed with cash. Since 1998, Beijing has injected more than \$260 billion into its

banks via straight handouts and by allowing the “big four” banks in China to shift nonperforming loans into separate state-backed companies.

One major reform is forcing lenders to hold capital equal to 8% of risk-weighted assets (as decreed by Basel I) by 2007 or face sanctions – including the removal of senior management. Almost all of China's 128 commercial banks have by now introduced better governance, shareholding and incentive structures, and independent directors on their boards.

The lure of China's high growth and huge population has attracted \$18 billion in foreign direct investment in China's banks in a single year. Three out of the four national banks have foreign partners, who have gained access to a branch network and client list they could never afford to replicate – even after WTO rules force China to open its domestic banking market fully from end-2006. Every deal is accompanied by a joint venture in savings and insurance products and credit cards.

Banks that expand into emerging markets like China understand that they face geopolitical risks and structural market challenges. Recognizing these obstacles upfront and addressing them head on will ease the process of market entry. But, it is almost inevitable that some investments will turn sour. Even in developed markets, expansion often requires long-term investments that could take years to become profitable.

2. Reconnect with the customer

Facing slow growth in many existing markets, banks are seeking to reconnect with retail customers through a combination of technology and personal service. A full 42% of banks surveyed identify technology as a top driver of profits over the next three to five years. Six of 10 banking industry respondents believe the greatest effect on profits will come from technology-enabled products and services. Nearly four of 10 (38%) cite the use of technology to build strategic alliances with customers, partners and other stakeholders.

Banks increasingly understand the need to improve the customer experience to foster loyalty and boost their “share of wallet.” Deloitte & Touche USA LLP's 2006 study, *Loyalty Quest: Enhancing the Retail Banking Experience to Drive Growth*, finds that US banks add checking account customers at an average rate of 17% a year, but lose them at an annual rate of 15%. Only a few banks see a net gain of more than 2% annually, and about half lose customers.

Convenience, value and service, rather than product innovation, are the keys to improving the customer experience as products are rarely differentiated and quickly copied. Convenience is the single most important factor in choosing a bank. In a survey of 4,600 Deloitte & Touche USA employees, 46% cite location and ease of access as the main factor in their choice of bank. And after years of shuttering branches, banks are opening new offices to attract, retain and cross-sell to customers.

Customers interact with banks in different ways: online, in branches, and through ATMs and call centers. A big part of a bank's competitive edge comes from the way customers feel about these interactions. Banks are innovating to present a consistent, personalized experience to the customer regardless of where the interaction takes place. Innovations to improve the customer experience include:

Convenience. A number of banks, including Bank of America and Wachovia, have jump-started initiatives to add new branches with extended hours, vivid color schemes and prominent logos. Bank of America has conducted experiments in branches aimed at measuring and reducing perceived waiting time, and has introduced palm-reading technology to give customers access to safety deposit boxes without a teller's help.

Value. Commerce Bank reimburses customers for fees incurred at the ATMs of other banks. Bank of America added a "Keep the Change" program in the fall of 2005, which allows enrolled customers to have debit purchases rounded to the nearest dollar and the difference deposited into a savings account.

Service. Washington Mutual, already well-known for inviting branch environments, has added children's areas. Citigroup plans to rollout a free service, "CitiMobile," which would let customers use cell phones to locate an ATM or branch, check their savings, checking and card balances, transfer funds and pay bills. And concierges have become commonplace at branches of banks large and small.

Many of these innovations require fully integrated customer relationship management (CRM) systems that allow employees to recognize customers and see all of their interactions and activities. Yet in an environment of growth by acquisition, integrating the systems of serial acquisitions has become a challenging task.

Commonwealth Bank, one of Australia's "big four" banks, has implemented a CRM system that allows a single customer view across all product lines. Externally, the system has helped the bank present a consistent face to the customer; internally, it has helped to establish consistent performance measurements and comprehensive sales training.

But banks elsewhere in the world face a more difficult task. Big US banks are still trying to make their mega-mergers work, and European banks appear to be on the threshold of a similar merger boom. In these regions, fast and smooth CRM integration will mean the difference between keeping newly acquired market share or losing it to local competitors.

3. Promote compliance

Regulation is second only to globalization as a transformative issue for banking over the next three to five years. Half of the banking industry survey respondents see regulation as one of the top influences on profits. Within regulation, more than eight out of 10 respondents (82%) cite the implementation cost

About the online survey

In November of 2005, we polled 50 senior banking executives out of 175 across the financial services industry to identify the key transformative issues in the next three to five years. An online questionnaire was used. Respondents were comprised of board members, C-level executives, business unit heads and other senior executives at large banks. The executives surveyed were based mainly in Asia-Pacific (16%), Europe (33%) and North America (43%), with the rest in Latin America and the Middle East and Africa. Institutions with assets of more than \$250 billion made up the largest single category (33%).

of compliance as having the greatest impact on profits. Nearly half (48%) see the risk of non-compliance as a top concern, and 46% cite the challenge of finding and training the right people.

Recent years have seen dramatic changes in the regulatory environment. Basel II (and Sarbanes-Oxley in the US) may ultimately enable banks to improve their management practices. At the same time, regulators have tightened enforcement of existing rules. And in many jurisdictions, each regulator has its own rules, restrictions and interpretations. The result is often a piecemeal approach to compliance, leading to decreased efficacy and increased costs. According to the Tower Group, 30% of IT spending by financial institutions on compliance is redundant, costing the industry \$10 billion a year.

A principles-driven approach to policies, standards and systems can simplify compliance. Client experiences suggest that the risk of non-compliance drops dramatically when the board and top management set the tone, accountability is woven into the business, the compliance role is clearly defined and the bank adopts a uniform methodology for documenting risks. The Institute for Financial Services reports that half of information technology managers at financial institutions want to address regulatory change through a single regulatory reporting utility, but that only 26% will succeed in achieving this objective.

4. Better manage risk

Risk is ranked among the top transformational issues over the next three to five years by four of 10 banking industry survey respondents. Banks view operational and reputational risk to be greater concerns than market, credit and liquidity risk, which they are generally able to manage more effectively.

As banks enter new markets, maintaining their reputation has become critical. Fully 46% of survey respondents rank reputational risk as one of the top three drivers of profits. This isn't surprising. A credit loss – even if substantial – is a cost of doing business easily absorbed by a bank's reserves or capital. Reputation risk has the ability to destroy market capitalization,

and in the extreme, bring down even a well capitalized institution, almost over night. As such, most of the executives interviewed believe that reputation is critical to success and needs to be managed throughout the business rather than solely through the public relations department.

Fifty-eight percent of those banks surveyed cite operational risk as a key driver of future profits. Among operational risks, data privacy and security have become a hot-button issue and will continue to be so for the foreseeable future.

Basel II provides a framework to address operational risk issues, improving banks' ability to develop key risk indicators and quantify the risk of operational loss events. It is unclear how many banks will adopt the Advanced Management Approach (AMA), Basel II's most sophisticated approach to operational risk. In the US, all banks implementing Basel II must use the AMA, but only about 20 US banks are expected to adopt Basel II. All EU banks will be required to adhere to Basel II but will be allowed to choose from three different approaches to operational risk. According to *The Banker* magazine, Rosemary Hilary, head of the Risk Review Department at the UK's Financial Services Authority (FSA), told an October 2005 conference that the FSA is expecting fewer than 20 applications for the advanced measurement approach (AMA) to operational risk¹.

Privacy

Banks have become increasingly vulnerable to data theft based on the sheer volume of information they assemble on their customers for both regulatory and marketing purposes. Recent losses of customer data by banks and credit card companies underline the magnitude of the threat, although in reality neither customers nor institutions have been significantly harmed. Perhaps they were just lucky, but one can't help but wonder if concerns over security aren't somewhat overblown.

Nonetheless, protection of their data is essential to customers' view of their banking relationship. In Deloitte & Touche USA's *Loyalty Quest* study, 86% of consumers said that keeping account information secure and protected was the most important factor in doing business with their main bank, well ahead of factors such as fees/rates, location and transaction accuracy.

By year-end 2006, the Federal Financial Institutions Examination Council (FFIEC) in the US will require banks to add to the user ID and password another layer of authentication for customers seeking internet access to accounts. Until global standards for authentication and identity theft management are adopted, banks must seek best-practice solutions, while adapting to local market requirements and practices.

The biggest threat to customer data increasingly comes from within the organization. The US Federal Bureau of Investigation identifies disgruntled employees and remote access to providers' systems as serious threats largely overlooked by organizations focusing on external threats.

5. Adapt to demographic shifts

Finally, impending demographic changes are seen as a key profit driver, cited by a third of survey respondents. The greying of much of the world's population will soon shift target customers from wealth accumulation to a lengthy retirement. At the same time, responsibility for retirement security in many markets is moving from the government and employers to the individual.

Banks in general have been slow to strengthen relationships with the baby-boomers within their existing customer base by developing protection products and advisory services. As the current wave of retirees continues for the next 20 years, and as the earlier retirees age, the need for advice and products to help retirees drawing down assets in the face of uncertainty will only grow.

In February of 2006, for instance, Wachovia started deploying retirement consultants to work in its branches. The advisors will provide education, marketing and sales assistance to help the branches sell more retirement accounts and annuities. UBS, Societe Generale and Standard Chartered all expanded their Japanese private banking practices in 2005, in large part to target greying boomers tired of low-yielding bank deposits.³

Insurance, with its annuity features and tax advantages, may represent one promising avenue for banks focusing on the needs of older customers. European banks have made headway in bancassurance – the sale of insurance through a bank's established distribution channels. Bancassurance is well established in such markets as Singapore and Korea, and has expanded rapidly in Japan following regulatory changes. China is seen as a fertile long-term market.

Looking ahead

Many of the bankers we surveyed felt that their margins would widen over the next several years. To make their vision of the future a reality rather than the more pessimistic vision of their no-growth or negative growth colleagues, banks will need to address five imperatives.

First, size matters: it offers a way to capture economies of scale and deliver products more efficiently. US banking consolidation may have largely run its course, but Europe's has barely begun, and the potential for cross-border consolidation has risen dramatically. Second, service matters – and technology offers a cost-efficient way offer customers more convenience, value and the "mass personalization" necessary to build loyalty. Third, to improve compliance quality while holding down costs, banks must be able to combine a top-down principles-based approach with enough flexibility to adapt to local regulations. Related to the compliance issue is the need to guard against operational glitches that could damage the bank's reputation. Finally, banks are facing an imperative to develop specialized products and advisory services aimed at an older population.

¹*Obeying the Regulator, The Banker, January 2, 2006*

²*Charlotte Observer, "Wachovia starts group of retirement consultants," Rick Rothacker, February 7, 2006*

³*Business Week, "A Battle for Japan's Boomers," January 9, 2006.*

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