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REPORT

Retail Banking: Facing the Future

THE BOSTON CONSULTING GROUP

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Note to the Reader

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Preface

With myriad trends shaping the global retail-banking landscape, it is sometimes difficult to see the big picture through the clutter of news and information that so often blocks a clear view of highly complex industries. Yet the fact remains that the retail segment brings in nearly 60 percent of total banking revenues worldwide. It is therefore critical that banking executives gain a clear perspective on the forces that are driving the industry's future.

There are many forces in play. Traditional barriers to open markets—both regulatory and political—are falling around the world and should continue to crumble, piece by piece. At the same time, maturing markets and significant consolidation in highly developed Western economies are forcing major players to sharpen their value propositions at home and broaden their horizons internationally in search of new revenue pools. As domestic battles for differentiation become fiercer and as numerous players attempt to plant flags in the same emerging markets, overall competition in the industry is becoming more and more intense. Margins, already under pressure in recent years, are being whittled down by this competition and should continue to erode gradually.

Also, the continuing development of emerging markets—most notably China, India, Latin America, and Eastern Europe—will offer opportunities. In Asia-Pacific alone, hundreds of millions of consumers that are not yet part of the banking system will seek banking services.

In addition to the demographics of financial exclusion, the demographics of age will be important. Aging baby-boom populations, particularly in the West and Japan, and more youthful populations in other regions will present fresh challenges for retail bankers. BCG's recent research on affluent middle-aged customers in the Americas reveals a surprisingly underserved preretirement market. Moreover, youthful customer bases, as comfortable with the Internet as their parents were with the fixed-line telephone, will speed up the already rapid rate at which direct and online banking are flowing into the mainstream.

The well of information that the Internet provides is also playing a role in the increasing financial astuteness of many retail-banking customers. This astuteness makes clients more willing to shop around for the best products and services, and will make them that much more difficult for retail bankers to please and retain in the future.

It was with thoughts such as these in mind that The Boston Consulting Group undertook a significant research project. This effort was aimed at helping retail banks identify the key trends that are affecting the industry, recognize the challenges they are likely to face both at home and abroad, and acquire the new skills and capabilities needed to be a market leader going forward. *Retail Banking: Facing the Future* is a direct result of this work.

We hope this report will be thought provoking and serve as a source of useful information for senior retail-banking executives seeking both to develop a differentiating and successful strategy and to take the performance of their institutions to the next level of excellence. For it is these banks that will determine the true nature of the future of retail banking.

Executive Summary

Retail banking will remain the dominant source of revenue for banks worldwide through 2015. In 2006, the retail banking business accounted for €1.22 trillion in revenues, or about 57 percent of the global banking revenue pool of €2.15 trillion.

- Fourteen banking groups earned retail revenues in excess of €10 billion in 2006, with five groups bringing in more than €25 billion each. Even for most of the top ten banking titans, retail business is still a critical revenue source—representing an average of 37 percent of total revenues.

- Through 2015, retail revenues will expand at an estimated compound annual growth rate (CAGR) of 3.2 percent in real terms. Factoring in an inflation rate of roughly 3 percent, overall growth should add up to about 6 to 7 percent. The retail banking business also continues to deliver a higher return on equity (ROE) than other banking segments. Most major banks currently achieve ROE above 25 percent (before taxes) from their retail banking activities.

- By 2015, the share of global retail-banking revenues generated collectively in the top five European countries and in the United States—which are all mature markets—will have shrunk by an estimated 5 percent, with matching collective gains in strongly growing markets in Asia-Pacific and the Middle East.

- Vast numbers of "unbanked" consumers in emerging markets—what we call the *next billion*—will take up banking relationships over the next generation. If such consumers in China, India, and Brazil were to generate 50 percent of the revenues currently provided by "banked," low-income customers in these countries, the amount of total new revenues produced by 2015 in these markets could be above €20 billion—the bulk likely coming from China.

Competition in the global retail-banking industry will become increasingly intense, driven by the continuing deregulation and opening of international markets, the ongoing regionalization and globalization of the industry, the expansion of direct and online banking, and rising customer expectations.

- The number of new entrants with attacking mindsets in regional markets will increase. Aggressive players—be they direct banks, product specialists, or traditional banks seeking to expand their scope—will continue to battle incumbents with fresh price and value propositions all over the globe.

- The well-known trend towards direct and online banking will change the nature of the industry significantly in terms of channel usage. This trend will gain momentum as adoption rates across all age groups increase and as more young people—who have been raised using the Internet—reach bankable age. This dynamic will inevitably lead to a further decline in the importance of bank branches for some sales activities, although branches will remain critical for customer acquisition and advice-intensive products.

- The transparency of the online world and the ability of sophisticated consumers to compare offers and

price positions will push the pendulum of power in the retail banking industry increasingly towards the customer, thus further pressurizing the competitive landscape.

The grip of margin pressure will continue to tighten. From 2001 to 2006, the banks in our benchmarking survey showed average margin declines in their retail segments of about 21 percent.

- Many attackers possess highly cost efficient and scalable business models that allow them to offer cheaper prices on a sustained basis. This fact, along with the ongoing shift towards online and direct banking, will lead the industry toward a new structural equilibrium at lower margin and cost levels.

- In some markets, attacking players have already taken sizable share from incumbents that have been reluctant to fight proactively on the price front. This trend will gain momentum as more new competitors enter the fray. Incumbents will either have to offer commodity products for certain segments at competitive prices or accept loss of market share.

- A key result of heavy price competition and its expansion into a wide range of products is that revenue pools will grow at a lower rate in many major markets over the next few years. This will make it necessary for banks to drive down their cost growth in order to keep cost-to-income ratios and profitability levels stable—let alone achieve more ambitious targets. Resizing and restructuring platforms to help achieve this will be a tall challenge for many banks over the next decade.

Tougher competition and tighter pressure on margins and costs will encourage increasing merger and acquisition (M&A) activity, especially in mature markets with low growth rates.

- In the future, we will see bigger, differently structured, and increasingly international deals. Given the current speed of both M&A activity and the forging of alliances, especially in the Asia-Pacific region, it is very likely that by 2015 there will be five to ten truly global banks.

- Cross-border mergers should be seen as having two, three, or more phases to allow sufficient time for factors such as platform, scale, and market dominance to come into play—and for all potential synergies to materialize.

The winning business models of the future have been taking shape in recent years and will continue to evolve. These models are exemplified by six general types of retail banks: global titans and regional expansionists, domestic champions, retail-oriented attackers, direct banks, specialists, and trading-up players.

- The first five categories of players have clearly outperformed the pack or showed the strongest improvements in recent years. They have an average advantage in their cost-to-income ratio of 10 percentage points, an average ROE advantage of 10 percentage points, and a revenue growth rate more than twice that of most other banks. They also dare to invest in organic growth and in acquisitions—their top-line growth allowing cost growth three times as high as that of most other players. The sixth category, trading-up banks, is well positioned to catch up in the future, especially if the leading players maintain focus and expand more aggressively.

- Between 2001 and 2006, direct banks and retail-oriented attackers showed the sharpest revenue growth of the six groups, with a CAGR above 20 percent, and at the same time achieved significant improvements in cost-to-income ratios. Nonetheless, despite direct banks' strong influence on overall industry margins and channel strategies, the largest share of direct and online banking will remain with multichannel banks. All models will show a stronger online profile going forward, and some interesting new combinations may evolve as new players arrive on the scene.

Over the next ten years, traditional incumbents will find themselves more engaged than ever on several fronts.

- Incumbents will need to develop sharper positioning and coherent new business models in order to defend their home markets and fight for share against an in-

creasing number of attackers. Because they have mature footprints, many incumbents seeking competitive advantage will turn to product innovation and bettering customer service. Products and pricing should remain easy to copy, the latter providing sustainable advantage only to low-cost players. Yet a small number of retail banks will realize long-term advantage by delivering a difficult-to-copy superior customer experience.

- Incumbents will also need to make direct and online banking a stronger part of their multichannel strategies and upgrade their skills in online customer acquisition and loyalty management. Winners will learn quickly from other industries and will transfer recipes for success to retail banking.

- Most future winners will have to be strong acquirers and integrators. Those that want to lead in emerging regional markets should be prepared to initiate at least one or two major mergers or acquisitions over the next five to ten years. Such moves can serve as powerful levers for defending market positions, widening scope, and increasing efficiency.

- To deliver a superior customer experience and achieve better cost efficiency, incumbents will need to fully exploit the power of process. On average, cost savings of 15 to 30 percent can be achieved through improved process efficiency, internally shared services, and outsourcing and offshoring. Strong consolidators can go even beyond that level. The continuing deconstruction of the value chain will help banks improve efficiency and fight margin pressure. A number of incumbent banks, however, may not be able to close process efficiency gaps.

- Incumbents will also need to build meaningful presences in chosen emerging markets that offer the steepest growth potential. Simply planting flags in numerous markets and achieving meager shares will not be a successful and value-creating strategy.