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Accelerate safely to survive and prosper

Sustainable banking – a return to accelerated transformation

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Where do you start when beginning transformation of this scale? Many banks face the same issues and hurdles. In this paper we discuss why banking transformation is imperative, but more importantly we look at how an organisation can successfully transform themselves at speed to maintain a competitive advantage.

Chris Monaghan
Partner, KPMG in the UK

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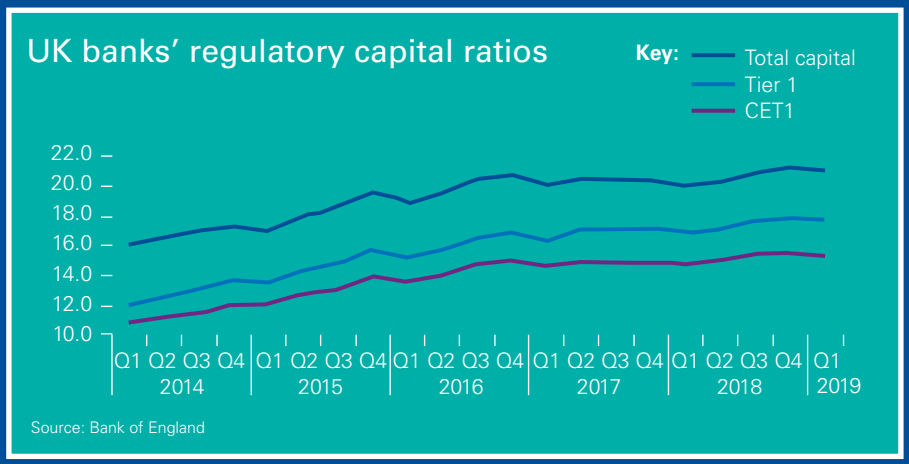
Introduction: the change imperative

The pressure on banks to transform has never been greater. Faced with a long list of difficult challenges, those banks that do not accelerate their transformation journeys now risk not just competitive disadvantage, but existential decline.

Since the global financial crisis of 2008, profit margins in the UK's banking sector have come under sustained pressure, with costs growing more quickly than revenues. Capital ratios in the sector have risen as regulators have sought to improve systemic resilience. Banks have found it tough to meet expectations for returns on equity, especially as investors have typically looked for returns in excess of 10%. The low-interest rate environment has added to their margin difficulties.

Today, these issues must be confronted in an environment where global trade disputes, Brexit and the low growth outlook are combining to create unprecedented uncertainty. At the same time, customers' expectations are greater than ever: they want seamless banking that is integrated into their day-to-day lives.

So how do banks rise to the challenge?



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Margins under pressure

Regulatory change continues to require a relentless focus, demanding new skills and raising costs for every function of the bank. Issues such as structural reform, Basel III and the financial crime regime are all proving to be more complex and expensive than originally anticipated.

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At the UK's five biggest banks NIMs have fallen by an average of more than **2.5%** over the last 24 months alone, while building society NIMs are down **5.5%**[1].

More positively, the big five UK banks have been able to improve their cost-to-income ratios (CIRs) over the last two years, reducing CIRs by an average of **4 percentage points** to **63.4%**[1].

Every sector of the industry has had to respond. In global banking, for example, increased volatility has prompted a flight to less risky assets, while the need to balance capital management against the imperatives of full-service provision has seen banks make major workforce reductions. In retail banking, the post ring-fencing era has been marked by increased competition, with the ring-fenced UK retail banks' fortunes inextricably linked to the fate of the UK economy. Consumers are benefiting from low mortgage interest rates, underpinned by retained capital in the form of domestic deposits. The competitive impacts on mid-tier and challenger banks have yet to be fully understood, but some have already retreated from property lending while others are reviewing their appetites for risk, with the availability of shorter-term, higher loan-to-value loans increasing.

The need to protect profit is fuelling a renewed push for consolidation, rapid cost-cutting and a focus on niche offerings that maximise the value of more bespoke clients. The potential is high for banks that are cash-rich and acquisitive; but to succeed, such banks must meet the expectations of their customers and deliver a lower-cost digital model, while avoiding damaging IT failures. Different stakeholder groups are scrutinising cost benchmarks to analyse the potential and performance of individual providers and broader market dynamics.

With the outlook for the majority of performance metrics in banking continuing to look troubled, the ability to enhance profitability through the speed and quality of transformation will be a key differentiation opportunity.

Banks have suffered a consistent deterioration in net interest margins (NIMs) in recent years. At the UK's five biggest banks – Barclays, RBS, Lloyds, HSBC and Santander – NIMs have fallen by an average of more than 2.5% over the last 24 months alone while building society NIMs are down 5.5%. Lower interest rates and the removal of the Bank of England's Term Funding Scheme will continue to negatively impact challenger bank NIMs, which are down by an average of 6.7% over the same period[1].

More positively, the big five UK banks have been able to improve their cost-to-income ratios (CIRs) over the last two years, reducing CIRs by an average of 4 percentage points to 63.4%. Still, the sector's leaders report CIRs of between 40% and 50%; and while many banks are ambitious, aiming for a further reduction of 10%-20% from refocused business lines and more use of cloud solutions across the estate, they will still struggle to match this. Even reductions of 25% would often leave them lagging the highly-focussed digital players operating with low-cost, modern platforms.

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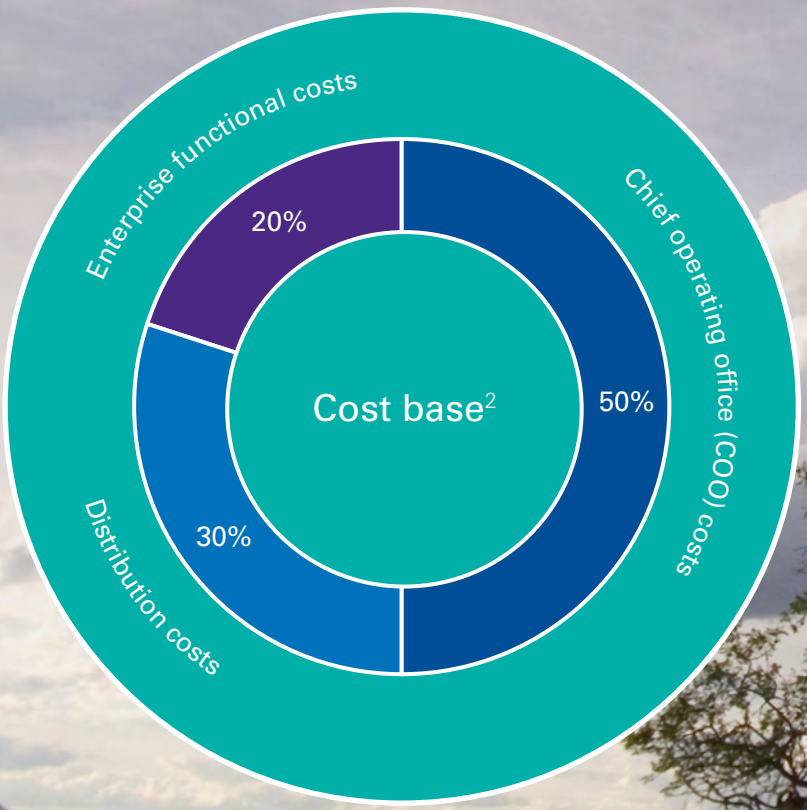
A roadmap for efficiency

With this challenge set, how will banks get there?

Well, stepping back to look at the total cost base across the industry, the average breakdown for banks broadly comprises:



Focusing on each of these areas, in turn, will pay dividends.

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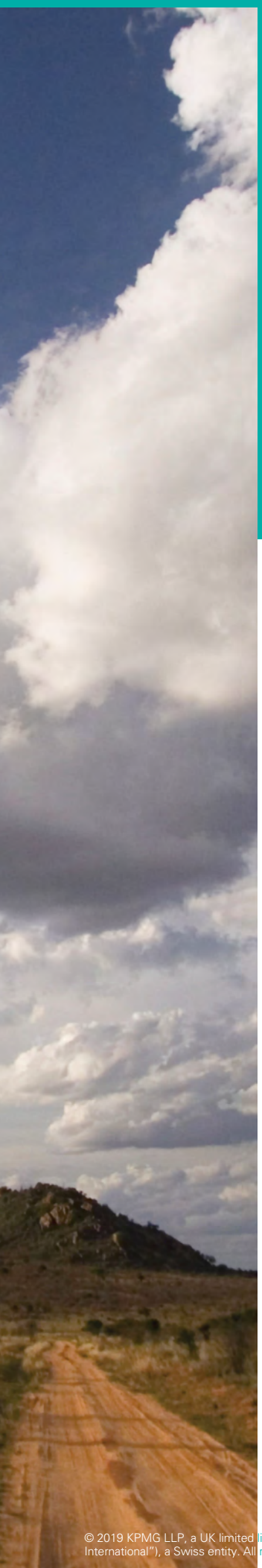

> **No bank is the same, but for most, COO and distribution provide the greatest opportunities for improvement.**

COO and distribution costs

There is now a significant opportunity for infrastructure simplification. Seizing that opportunity will require banks to focus their efforts on cost reduction, improved customer experience and enhanced resilience.

There have already been notable successes: for example, rationalisations of expansive branch networks and the greater personalisation of everyday banking services such as payments and mortgage renewals. But most banks can deliver many more of their existing banking services through mobile apps and straight-through processing. Also, the introduction of open banking and open data will enable the integration of banking experiences into customers' day-to-day lives and give them access to a broader ecosystem of services, driving growth.

Front-to-back IT transformation will help banks secure these competitive advantages, though the process is not without risk. There has been a steady increase in the volume of IT outages reported to the regulator, with individual banks often paying significant penalties[3]. Moreover, complex technology programmes require significant expenditure.

Given these concerns, banking executives will need to build stakeholder confidence, provide funding and take the lead. Critical success factors will include the speed of transformation, organisational agility and the ability to show tangible signs of improvement in customer experience and cost reduction at an early stage.

No bank is the same, but for most, COO and distribution provide the greatest opportunities for improvement. But there will be tensions to manage: realising those opportunities is likely to be a medium-term journey for the big players, generating a stretch between investors' desire for returns, customers' expectations on service and executives' capacity to execute.

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Enterprise function costs

Enterprise functions – and in particular risk and compliance – offer significant opportunities too given the way costs have increased in recent years. The cost of regulation has been a major drag on banks' costs. The average building society has seen its CIR increase by 4 percentage points over the last 24 months to 64%, while at challenger banks attempting to scale, the typical CIR has risen 2.4 percentage points to 60.9%[2].

In fact, this has been the story of the last decade. The cost of operational compliance such as know-your-customer and transaction monitoring has risen up to 5 times[2]; that's before the cost of operational resilience, where banks of all sizes across the market are now starting to focus their attention and budgets.

Banks naturally have different risk profiles and give their compliance and risk functions different types of mandate. Some functions have taken on significant additional tasks since the crisis, including debt restructuring, work-outs, collection, customer remediation and regulatory change programmes; their resources were therefore increased and to varying degrees, this may not have rebalanced. That said, mandates are now being rebased: accountabilities for risk management are increasingly being transferred to Line 1 and Line 2; compliance and risk functions are becoming leaner and more strategic.

Still, while costs peaked during the crisis both in actual and relative terms and are now falling at some banks, there is still a significant range across firms within the retail and commercial banking sectors.

Factors driving costs down include:

1. Top-down cost reduction programmes.
2. Requiring Line 2 to assume risk ownership and risk management responsibilities.
3. The development of end-to-end customer journeys.
4. The adoption of more strategic mandates for compliance and risk, resulting in a more focussed set of key activities.
5. The selective adoption of technology, though this is often contingent upon significant improvements in the quality of underlying finance and risk data.

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Banks with further to go on risk and compliance costs may want to embrace more of these activities, but for all banks, it is imperative not to lose sight of regulatory expectations. The challenge is to achieve and maintain an effectiveness threshold while doing so as efficiently as is feasible.

There is limited data on the relationship between effectiveness to efficiency across comparable banks, though it is possible to impute a range of cost-efficiency. The bulk of banks before the crisis clustered in a range of 2.5% to 5% of total costs, but during the crisis, some firms reached as high as 8% to 12%[1], chiefly due to remediation and burden of regulatory change. Since the crisis, the trajectory has been downwards, particularly amongst pure retail banks that have rationalised their product range and systems, and are free of legacy issues. Some of these firms are close to 2%, though most are clustered between 3% to 6% while making further progress[1]. There are also some outliers, particularly amongst banks that have not yet automated processes and which rely heavily on expert judgment.

In the building society sector, lack of scale, low profitability and poor systems have rendered some mid-range societies increasingly uneconomic and uncompetitive. Senior management in such societies often relies heavily on compliance and risk functions as they make commercial and strategic decisions. The cost of such functions may represent as much as 8% to 10% of the total cost base.

In the major ring-fenced banking subsidiaries of the key UK banking groups, the overall trend is to progressively reduce the costs of compliance and risk, while not jeopardising effectiveness; the aim is to get costs below 2%[1]. This is usually highly contingent upon the relative maturity of Line 1 and its ability to effectively manage its risk profile, particularly its credit conduct, operational and financial crime risks.

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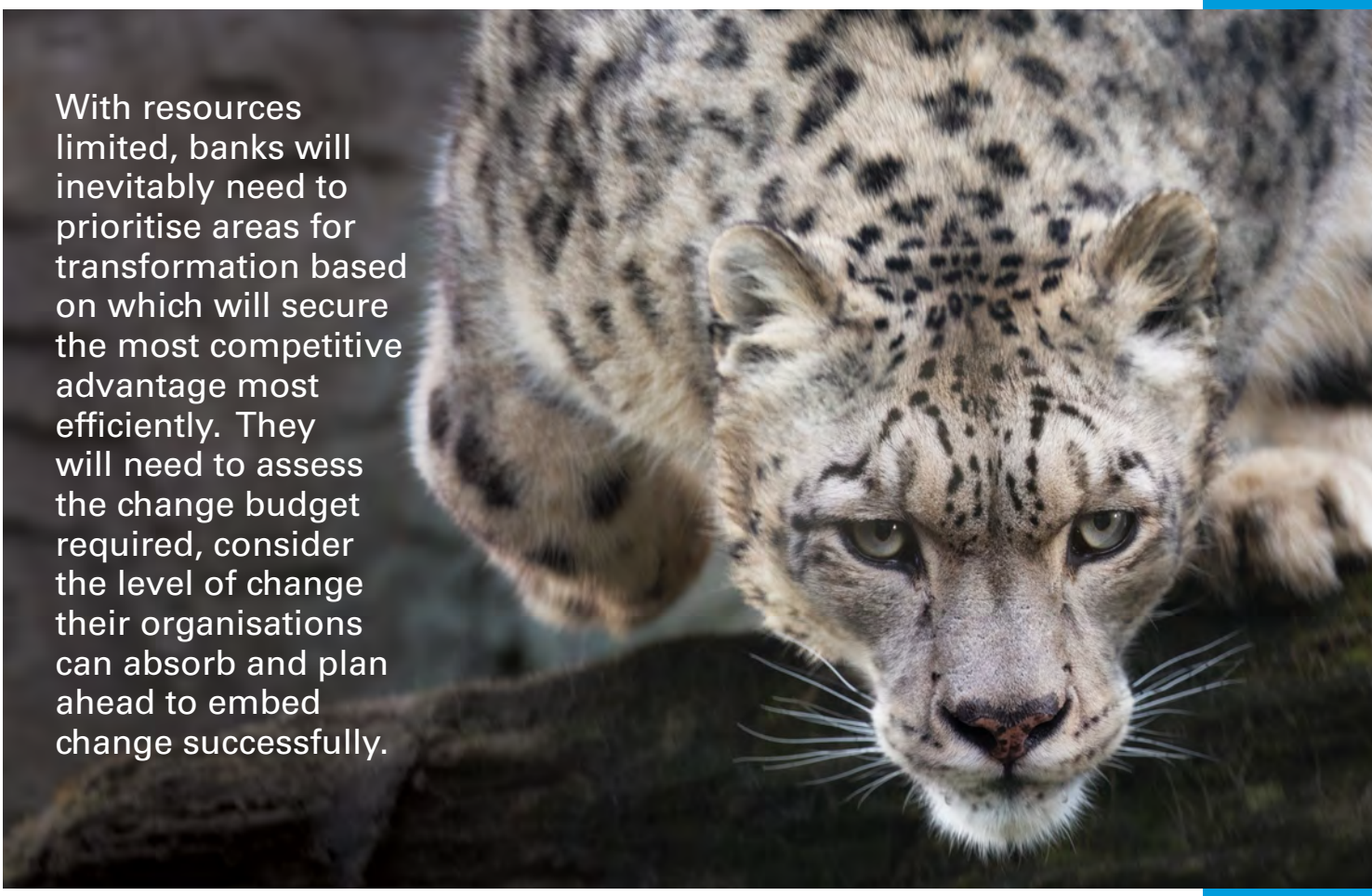

With resources limited, banks will inevitably need to prioritise areas for transformation based on which will secure the most competitive advantage most efficiently. They will need to assess the change budget required, consider the level of change their organisations can absorb and plan ahead to embed change successfully.

Prioritise for transformation impact

On budget, one useful indicator can be change spend per full-time equivalent (FTE); this metric can be a good gauge of ambition and likelihood of success, with larger and mid-sized banks spending an average of around £23,000 per FTE[1]. But bear in mind that this figure will naturally increase as the scale, pace and complexity of change increases and headcount levels reduce as efficiencies are delivered.

The bottom line is that banks face having to spend more than ever before on change as they seek to transform their operating models towards end-to-end, data enriched customer journeys. Those journeys will ultimately be heavily automated, albeit with high-empathy human touch sometimes infused, and therefore underpinned by a modernised IT estate that is largely cloud-hosted.

The best banking transformations employ agile delivery techniques at scale. Process simplification and automation activities have become commonplace in reducing costs, so focusing now on smart use of data and analytics, combined with machine learning and artificial

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intelligence, provides room for differentiation and cost reduction simultaneously. Delivering front-to-back authentic experiences that are fully automated from the first interaction, through the decision-making process and on into lifetime value will help drive a step-change in experience and efficiency. It may also go a long way towards helping banks achieve their CIR ambitions.

In practice, each bank's precise focus and mix between legacy maintenance, regulatory compliance and digital transformation will reflect its situation – and particularly the business strategies adopted in previous investment cycles. High-profile system failures in recent years have caused significant reputational damage and IT and operational resilience have become key focuses. Banks expect to be always on.

Still, many banks have made good progress. In the past five years, they have significantly increased spending on innovation and digital transformation – and the larger budgets allocated to regulatory requirements since the crisis should reassure customers and other stakeholders. That said, there are also banks for which core programme disciplines such as rigorous portfolio planning, prioritisation and integrated design are still sub-optimal. They require greater focus and an infusion of skills – both in volume and capability terms.

Tax is one area to consider in this context. On the plus side, the UK offers several tax incentives in return for innovation - R&D tax credits and the Patent Box, for example - which could reduce the cost of transformation. But there are also potential cost issues. Banks, already facing the introduction of financial transaction taxes in some countries, may also suffer from the advent of new digital services taxes. Aimed at consumer-focused platform businesses, these have the potential to drift into financial services as products and services become increasingly electronic and stateless. As tax legislation evolves, it will be vital to assess the impact of these changes on both existing and new products – for example, new digital services enabled by open banking. More broadly, the scale of transformation under consideration will naturally prompt many banks to review their legal entity structures, balance sheets and debt maps; reorganisations and rationalisations may have important tax impacts.

Banks require greater focus and an infusion of skills – both in volume and capability terms.

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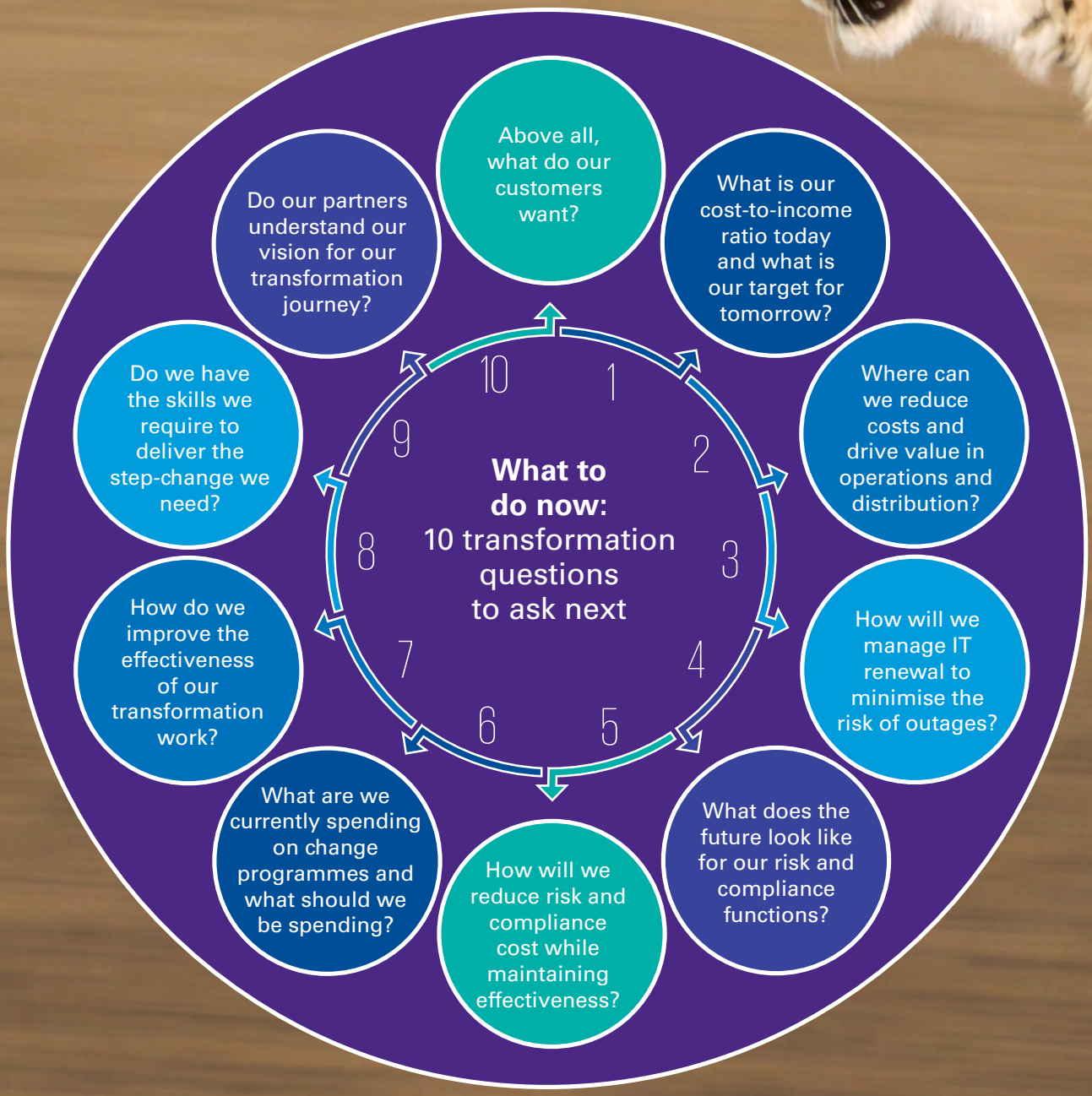
Conclusion: change faster, change better



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Given the headwinds buffeting the broader UK economy, banks' ability to execute change is as important as ever. But UK banks recently surveyed by KPMG typically gave themselves a change effectiveness score of less than 5 out of 10. The change function of the future must be leaner, able to deliver more effectively and more quickly, potentially relying on more help from trusted partners. To be both safe and successful in transformation requires banks to spend more time articulating and securing outcomes, rather than sourcing inputs from their partners. They must complete the change cycle faster.

In short, the need to transform quickly for value is intensifying but execution risks are increasing too, with platform outages having severe consequences. Scale players will require integrated planning that includes M&A and digitally-anchored cost-cutting. Mid-sized banks will also need to execute quickly, though their focus may need to be more singular in the race to be sustainable over the longer term. Smaller players will require a high focus on differentiation and specialist banking products that don't generate enough volumes for larger players.

Banking may see less competition as some banks struggle to keep pace with the changing needs of customers. All participants must be capable of determining the right mix of value transformation and of executing each specialism efficiently while maintaining a resilient platform and a laser focus on customer experience.

Building and retaining capability in customer experience, organisational agility, functional specialism and stakeholder management will be critical factors for success.

To be both safe and successful in transformation requires banks to spend more time articulating and securing outcomes, rather than sourcing inputs from their partners.

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Contact us

Chris Monaghan
Partner, Financial Services
Operational Transformation
KPMG in the UK
+44 (0)20 7694 5008
chris.monaghan@kpmg.co.uk

Julian Morgan
Partner
KPMG in the UK
+44 (0)20 7694 2100
julian.morgan@kpmg.co.uk

Adrian Harkin
Senior Advisor, Banking
KPMG in the UK
+44 (0)141 300 5822
adrian.harkin@kpmg.co.uk

Jonathan Brown
Director, Banking
Operational Transformation
KPMG in the UK
+44 (0)7810 656 153
jonathan.brown2@kpmg.co.uk

Thomas Maddern
Senior Manager, National Markets
KPMG in the UK
+44 (0)161 838 3447
thomas.maddern@kpmg.co.uk

Georgia Hunter
Manager, Banking
Management Consulting Operations
KPMG in the UK
+44 (0)7881 234 859
georgia.hunter2@kpmg.co.uk

kpmg.com/uk

1 Source: KGS benchmarking of publicly available banks financial statements.

2 Source: KPMG UK benchmarking from project work.

3 Source: Treasury Select Committee, *IT Failures in the Financial Services Sector Review.*

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