


# Building the bank of 2030 and beyond

The themes that will shape it



Building a better  
working world





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# Foreword



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Global banking in the first decade of the 21st century began to change across multiple dimensions. A financial and sovereign debt crisis, predominantly among Western economies, set the scene for a fundamental rethink of the role of modern banking and led to profound regulatory and business model changes. The consequences of these changes are far from clear in 2013, and to attempt to point toward a future state of banking as far out as 2030 is rather ambitious.

The purpose of this paper is to do no more than highlight some of the major trends and drivers of that process of change that bank boards, strategy teams and corporate development officers (CDOs) will be required to actively consider. New skill sets will be required to deal with change, and those banks that remain agile, strong and strategically decisive will no doubt find many templates upon which to build successful business models for the future.

From the perspective of 2013 it is clear that a number of business models today are no longer fit for purpose and that substantive change is required across large parts of the banking industry. Which products and services are capable, under the new regulatory regimes coming into force, of generating a sustained return above a now much higher cost of equity? How can banks completely transform their cost bases, and hence core processes, to realign their business models to the new normal? What are a bank's fundamental value proposition and core service offerings to be – does a bank now have to articulate a clear social purpose as well as acknowledge its stakeholder obligations? It is important not to underestimate the role of aligning cultures, behaviors and rewards in a manner that is satisfactory to all stakeholders.

The types of service, functionality, experience and customer fulfillment provided by industries other than banking are evolving rapidly and setting a high bar of expectation for banks to meet in the coming years. This raises important questions about how banks come to understand the costs of providing all of this in the rapidly evolving and costly regulatory environment of the future.

Banks will be required by customers and regulators to do all of this in a transparent and fair manner and in a way that demonstrates the value they bring to customers. It requires a compelling proposition that also attracts an appropriate level of sustainable revenue. It raises questions about how banks will segment their available markets and determine what is core to their proposition. Big data capabilities will become increasingly important both to manage risk adequately and to serve, through micro-personalization, their retail and corporate customers.

Between now and 2030 the currently understood value chain in banking will no doubt have fragmented and re-formed in a number of as yet unforeseen ways. There will be a level of fluidity over this period in how banks interact with the shadow banking world in which other industries will have occupied some of the territories formerly understood to be core to banking. Banks will also face some far-reaching questions. Will the payments industry become a utility function, supported by technology-enabled online retailers and social media sites? Will lending to SMEs or retail have become substantially disintermediated by peer-to-peer lenders? Will the "socially useless" component parts of investment banking have been hived off into smaller partnership boutiques and multi-asset manager platforms?

All of these factors will drive inorganic activities in banking, and we expect M&A will continue to be an important tool to drive the necessary reshaping to come. While ultra-large transactions are likely to become the exception, we forecast continued high levels of mid-sized and smaller transactional activity directed toward fulfillment of the "business-model-driven changes required." Banks will continue to sell or swap operating businesses as well as portfolios of risk-weighted assets, and many in Europe may retreat, at least temporarily, to more national boundaries and ambitions. At some point the stronger and more agile players will actively resume their growth-oriented agendas. They will seek to geographically reposition their businesses to take advantage of the long-term demographic and social reshaping of the world's population and consequent geo-political influences.

This paper reflects on eight major themes banks will want to consider as they drive through their own reshaping and business model transformation agendas. We also draw out some practical implications for building the bank of 2030. The eight themes we identify will require adopting of new skills and approaches, as well as building on those that are already familiar.

Inevitably, in an exercise of this kind, we will get many things wrong or at best underestimate the importance and weightings of relevant circumstances. We have deliberately avoided any major forecasts, although we have used certain analysis performed by others to illustrate some of our key points.

The pace and direction of change is all too difficult to predict, but we hope you find the ideas contained herein thought provoking and at least worthy of consideration as you assess potential M&A activities against an uncertain and fast-moving change agenda. We would of course be delighted to discuss with you further any of the thoughts and ideas raised in the paper.

# Executive summary

## Introduction

Before embarking on an analysis of the themes that will dominate the next two decades, it is worth remembering how much the financial world has changed in recent history. In 1970, the banking industry in the developed world operated under domestic constraints on everything from consumer credit to its structure. Internationally, the Bretton Woods system of managed exchange rates was still in place, with the US currency tied to gold. China had yet to emerge as the factory of the world, and neither had the internet as the global superhighway. Before the “Great Moderation” set in at the end of the millennium, the financial system went through a period of high inflation and aggressive counteraction by central banks, with high interest rates triggering property-related banking crises on both sides of the Atlantic. Financial crises also had to be faced in Latin America (during the early 1980s) and in Asia and Russia (during the late 1990s).

## Financial liberalization

In the 1990s and 2000s, banks in the developed world enjoyed an extraordinary period of liberalization. The UK’s “big bang” deregulation of 1986 gave a push to cross-border investment banking, which in turn undermined other regulation – notably the US Glass-Steagall Act separating commercial banking from brokerage firms (finally repealed in 1999). Bancassurers from continental Europe expanded into investment banking, and US investment banks expanded into commercial banking. Both fed the growth of capital markets to fund private sector ambitions while mitigating risk through diversification and the development of derivative hedging instruments. The moderation was driven more by the disinflationary effects of China’s arrival as a cheap global supplier of goods and labor and by a period of relatively low commodity prices.

## Reregulation

After this end to complacency in the West, the shared view of politicians and regulators in many parts of the world is that the financial industry cannot be left to mind itself. The greatest reregulation since the 1930s has included the Dodd-Frank Wall Street Reform and Consumer Protection Act in the US and the global tightening of bank capital requirements via Basel III. In Europe, a range of new directives is being implemented, including Capital Requirements Directive IV and the Markets in Financial Instruments Directive (MiFID II), among many others. The changes are exerting centrifugal forces on banks that could reverse the consolidation that occurred before – and during – the crisis. The US’s Volcker Rule requires the spin-off of proprietary trading; the UK plans to ring-fence domestic retail/commercial banking from investment banking; global regulation is raising capital requirements for both systemically important financial institutions and trading; and recovery and resolution plans are required in order to describe how a bank would be resolved. These changes are forcing realignment of businesses and operations. Boards are asking themselves: which activities are worth keeping together?

Game-changing regulation is being accompanied by game-changing politics and economics. These are linked: the financial crisis has undermined belief in unfettered free-market capitalism, while China’s success so far with state-directed economic development has raised hopes that this can be a sustainable alternative model. In the coming decades, however, state-directed systems will have to balance the competing demands of economic growth with requirements of a growing middle class for public goods, political freedoms and a high-quality urban living environment. Economic power is nonetheless switching from west to east and north to south (except in Europe) as the developed world deleverages, constraining demand. Notwithstanding short-term concerns over increased costs of funding for banks, Asia, Latin America and the Middle East are now the major drivers of global economic growth.

**In this document we have outlined eight themes that we believe will shape the next 20 or so years and, in particular, impact the banking industry.**

### **A new assertiveness from government**

This has led to a debate about whether capitalism itself is in crisis. At stake is the extent to which governments – democratic or otherwise – control industries; whether this is achieved through tighter regulation or ownership of assets; and whether markets are the means of liberalizing trade and corporate transactions, or controlling and taxing them. In the developed world, it is clear that government motives have changed. At a philosophical level, inhibitions on interference have been removed. At an economic level, rescues of financial institutions, combined with post-crisis recessions, have left many governments in the developed world with annual deficits and inflated debt levels. In certain EU countries, the level of sovereign debt has reached crisis proportions. Cash-strapped governments need to raise taxes, and those taxes tend to fall on the most politically sensitive sectors: banking is clearly one of these, and so is natural resources.

### **Innovation will be an important driver of change**

The so-called financial engineering of complex financial products during the financial crisis, along with challenges of legacy IT systems, have detracted from the industry's reputation as an innovator of "socially useful" services in recent years. Banks are mostly large, complex organizations, which inherently presents certain barriers to their ability to innovate. However, innovation is nonetheless high on the agenda of many, including new ways to streamline operational processes and improve customer experience. Small, innovative players have begun to develop and take ground from traditional players in a range of areas including lending and payments. This includes peer-to-peer lending, which effectively disintermediates the lending process, providing high rates to savers and lower rates to borrowers. It also includes mobile payments, which, when coupled with "stored value" functionality, can represent an alternative to banks. These competitors remain small compared with banks but are demonstrating the ability to grow extraordinarily quickly. Banks may in turn choose to acquire, or partner with, these innovators.

Over the next two decades, much depends on whether the view at the start is optimistic or pessimistic.

## **1. Nationalism vs. globalism: placing limits on the global model**

The competing forces of nationalism and globalism have both political and economic dimensions. Consequently, banks are faced with difficult choices in determining global strategy and footprint. These forces will also impact banks' ability to enter or exit markets inorganically and may place other constraints on factors such as ownership structure and repatriation of funds.

Banks can address this strategic conundrum by placing their individual customers at the heart of decision making. Another feature of the bank of 2030 is likely to be a strong structural vision, informed by regulatory, political and business requirements.

## **2. State capitalism: a new force in global banking**

The bank of 2030 will be required to take account of the state to an unprecedented degree. While the precise regulatory architecture at national and international levels is still a work in progress, the incursion and involvement of the state in both the structure and daily operations of financial services – particularly banking – is inexorable and irreversible.

While the prospect of close state involvement will fill many in the industry with trepidation, the definition of this new relationship will produce manifold opportunities for the innovative. In areas as diverse as pension and health provision, infrastructure, housing and economic development, resource-constrained governments will welcome partnership with institutions able to contribute and generate ideas, capital and operational skills.

### 3. Trade flows: a source of opportunity and volatility

So much is written about the growth in trade between developed countries and emerging ones, as part of the globalization story, that it is easy to forget that most trade flows take place within regions rather than between them. The intra-regional nature of trade supports the case for strong regional champions to operate alongside global banks. Trade financing services offered by banks are the lifeblood of international trade, allowing firms to finance and transact business globally.

A 2013 EY report, *Successful corporate banking: focus on fundamentals*, highlights that while executives are pleased overall with their current core team of banks, a lack of consistency in the quality and delivery of services across geographies was seen as a challenge in working with banks. This challenge of meeting customers' expectations across a wide range of markets comes at a time when many global banks are rationalizing their international footprint and focusing on core geographies. As trade volumes grow in future decades, this must be seen as a key challenge to address.

Banks will therefore be required to consider a range of strategies for meeting customer requirements. In certain markets this may involve partnership of global with local or regional banks, with the compatibility of products and systems being an important consideration. Banks need to consider how best to combine the best in class local market experience with the advantages of being a single global provider, recognizing that customers will manage multiple relationships to achieve their goal. This presents opportunities for both global and local banks.

### 4. Investment in new markets: the emerging will have emerged

A new investment boom, which could last for decades, has started in the emerging world. This trend contrasts with a general decline in investment (as a share of GDP) in much of the West, which has been ongoing since the mid-1970s. By 2030, many markets that we currently refer to as "emerging" or "growth" markets will have reached maturity. Such references to BRIC countries will be long-since superseded and they will be replaced by a new set of high-growth markets. The emergence of Africa as a strong-growth region is underpinned by a host of factors, including strong foreign direct investment (FDI) flows, increases in the quality and quantity of educational provision, the availability of natural resources and growing domestic demand.

Major global banks that want to compete in emerging markets have a number of choices, but entry by outright acquisition is the most sensitive. Much depends on the sensitivity of the sector, and banking tends to be political because of the state's interest in the role of credit in promoting growth and as guarantor of deposits. Short of controlling stakes, partnerships or joint ventures can be sought with local firms, which may be seeking capital and expertise to assist them to grow.

### 5. Demographics: serving an older, more urban generation

By sheer population size, the emerging world dwarfs the developed world by about five-to-one. United Nations' forecasts are for the overall population to reach about 8.3b by 2030 – 1.3b more than at present – and for the (currently) less-developed regions to make up 7.0b of that. This population lives an increasingly urban lifestyle, reflected by the fact that in 2008, for the first time in history, over 50% of the world's population lived in cities. The population is also aging – the population within the 15-64 age group globally (the so-called "demographic window") will continue to grow for most of the 21st century but has already begun to decline in some developed countries.

There are opportunities to provide new services to an aging and increasingly urban population. This includes, for example, improving offerings to savers and better enabling the elderly to run down their accumulated wealth to support a quality of life they are accustomed to. Population trends are some of the most stable and reliable of long-term predictions and therefore provide a relatively firm base for future planning.

### 6. Retail customer relationships: more personal, greater trust

Retail banking is changing, with customers taking more control of the relationship. They are changing their bank more frequently, buying products from more than one bank, and demonstrating a preference for tailored products and services. By 2030, relationships between customers and their banks will look very different from today as technology provides ever-greater possibilities to broaden and deepen them.

Banks will use deep data analysis and new techniques for the cost-efficient experimentation to provide high levels of customization. The bank of 2030 may look, from the outside, like hundreds of banks, each with a specific product offering that suits a segment of customers. Major cultural change, which is already underway in many organizations, will have revolutionized the industry's relationships with customers by 2030. The bank's values will be understood and respected throughout the organization (as well as by its regulators) and will be linked to the performance management of its staff.





## Our approach

"If we are to have any prospect at all of usefully describing what the bank of 2030 should look like, and hence what the challenges for those charged with building it will be, we have to attempt to develop an image of what we think the world may look like. One could attempt to construct a whole set of scenarios, most of which would turn out to be entirely wrong. Or perhaps, more usefully, we can attempt to tease out some of the grand themes that will characterize the next 17 years or so, and establish some working assumptions for bank boards, strategy teams and CDOs alike.

"What is perhaps interesting here is not so much our inability to chart the specific turn of events with any precision, but the observation that history is rarely linear and frequently circular or, perhaps more aptly, 'revolutionary.' What is prescient is the ability to spot an inflection point, the point at which history takes a radical detour from what had previously seemed to be an ineluctable and entirely predictable path, sometimes to return upon itself. In modern times, 28 July 1914, 8 May 1945, 9 November 1989 and 11 September 2001 are arguably pivotal dates."

**Philip Middleton**, Senior Advisor, EY, UK

## 7. Payments: new markets and new models

Technological change is occurring at such an extraordinary pace that many developments that will occur by 2030 are unimaginable today. These developments will impact the speed and flexibility with which products and services can be provided to customers, as well as reducing the cost of providing them. Payments are one area where these trends are already beginning to take shape.

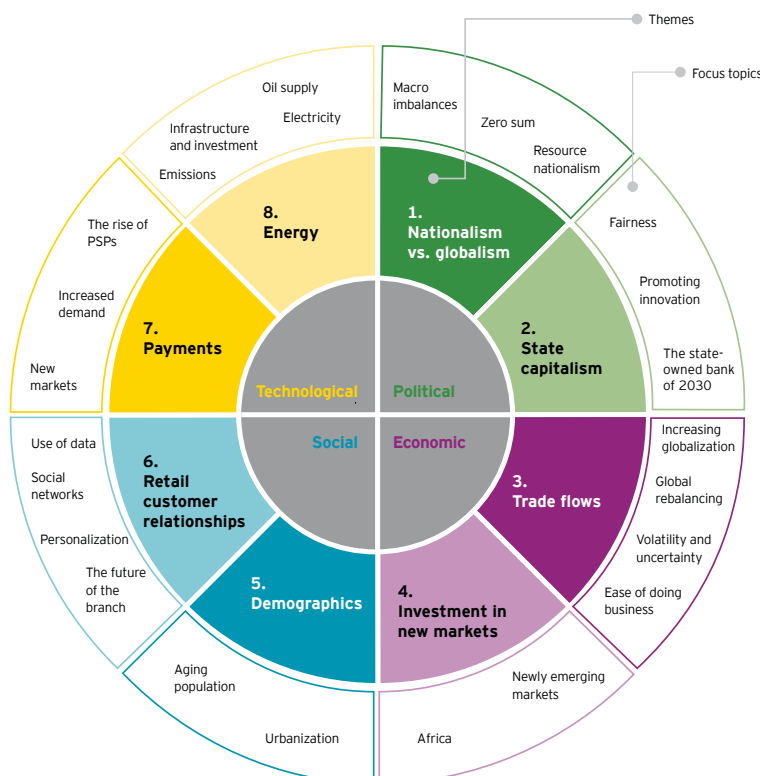
Certain of the emerging skills and technologies required within the payments industry are outside the core competency of a bank. Other ways in which to participate in this attractive market will therefore become more important, involving a different skillset to the acquire-and-control model. These forms are not new but are underdeveloped in financial services and include joint ventures, where the other party provides market knowledge, technological know-how and distribution.

## 8. Energy: technology is challenging the old order

The technological advances of recent years have shown that many previously unavailable resources can be brought within reach. This is demonstrated particularly well by the shale gas revolution within the US but also by advances in the offshore oil industry. Many other technological innovations, including within the renewables sphere, are likely to arise in coming years and disrupt established patterns and forecasts.

Increasing energy demand, new technology, and the complex political and environmental dimensions associated with the industry have far-reaching consequences. As a result, there will be major changes in the way energy is generated and delivered within the next two decades, with important implications for banks that finance the activities. For these reasons we focus on energy, rather than the broader topic of natural resource availability, as our eighth theme.

For big energy infrastructure projects, helping governments and multinational companies to raise funds is likely to continue to be a major source of activity for banks. Changes in energy production methods will also require a new suite of risk management and hedging products (such as the emergence of a gas futures market) in order to underpin the investments made in production and supply infrastructure.



We would suggest that some or all of the following eight themes will be key determinants in shaping the world in which financial institutions will operate, and which will have major influence on the shape of the bank of 2030, and the work necessary to build it. In the outer ring of the diagram to the left we have highlight some of the key topics explored further. In focusing on eight themes we inevitably had to omit many areas of potential interest. This includes many broader questions on natural resources, technology, health, wars and geo-politics.

Alongside our exploration of the eight themes, we have considered how they will impact the financial services industry. In particular, how can businesses evolve to take advantage of new opportunities and to respond to new forms of competition? Many components of the existing model will come under review in the two decades and, because most are interconnected, the successful banks will be those that consider them together and make bold decisions across the organization.



# 1. Nationalism vs. globalism

## Placing limits on the global model

History is full of incidents of borders being opened or closed to trade. Sometimes this is due to imperialism as countries used military might to gain or reinforce access and sometimes this is due to protectionism as countries jealously guarded incumbent interests against competition or outside control. The second half of the 20th century saw trade in the ascendancy, allowing increasing numbers of people to benefit from access to cheaper raw materials and labor, and to new markets for products and services. This was linked to a democratization of access to information about how other people lived. There was also a literal spread of democracy to countries such as India and in central and eastern Europe that had previously been part of empires.

Francis Fukuyama wrote in *The End of History and the Last Man* (1992), "What we may be witnessing is not just the end of the Cold War, or the passing of a particular period of post-war history, but the end of history as such: that is, the end point of mankind's ideological evolution and the universalization of Western liberal democracy as the final form of human government."

At first sight he was right for the next 16 years – until the financial crisis. But how can that view be reconciled with the rise of China, which is not a liberal democracy? And if the view is more nuanced, was he tapping into something else in post-war history?

If the answer to the latter question is yes, then the liberalization and ideological revolution that he celebrated would be exemplified by the growth in both global trade and access to funding – via banks and capital markets – for consumption and investment. This means there is a symbiosis between producers and consumers, and between capital providers and the companies or state agencies putting that capital to work. Both consumption and investment create employment, raising income levels, and that feeds back into consumption or savings/capital formation.

### Optimistic outlook

Optimistically, by 2030, the post-crisis decade will be seen as a transition to another period of stability, during which the globalization of trade and the deepening of capital markets spread to the less-developed parts of Asia, Latin America and Africa, raising living standards.

Far from suppressing financial innovation, the era of deleveraging prompts the industry to play its part by finding new sources of, and channels for, finance. These resources can be employed in growing markets, where bank clients include a growing number of private sector businesses and affluent individuals, as well as government agencies.

### The tipping point to a zero-sum game, or worse

The zero-sum philosophy sees one country's gain as another's loss. This leads to nationalism, protectionism and a failure to co-ordinate action on global threats, such as nuclear proliferation or climate change. It is not difficult to find examples of governments halting cross-border flows of goods or capital. India has banned cotton exports twice in the past two years to protect domestic textile companies.

Sanctions against Iran to deter its development of nuclear capability have hit its oil exports. This has helped drive up the global oil price, demonstrating that trade blocks can have political causes that over-ride economic interest.

Capital flows have been curbed in countries as diverse as South Korea, Brazil and Russia to try to reduce the volatility in currency and asset markets that accompany the rapid inflow and outflow of "hot" speculative money. The currency war theme was voiced by Brazil's finance minister in 2012 when the country put strict limits on the shorting of the dollar against the real. The central banks of both Switzerland and Japan have acted to halt the strengthening of their currencies. With many countries either dependent on exports to maintain growth rates (e.g., China, Germany) or aiming to increase exports to aid economic recovery (e.g., the US, UK), motives are skewed toward competitive devaluations, or at least blocks on revaluations.

At the time of writing, US unemployment was falling and the trade deficit narrowing. But the sensitivity of the Chinese Government to social unrest if the economic growth rate falls too rapidly means the drive for exports will be a hard habit to modify. The same might be said of Germany, where increased consumption would increase export markets for struggling south EU members. If exporters do not switch to consuming more, they may provoke a return to the "beggar thy neighbor" protectionist policies of the 1930s. The collateral damage for the financial sector would include the bankruptcies of corporate clients reliant on cross-border markets or supplies, a plunge in asset values in countries that were no longer open to cross-border business and a general dampener on fee-generating activity.



## Political skills

“Private sector firms with a developed market background may need to add to and adapt their skillset, which has typically been based on relatively objective assumptions about commercial returns and risk pricing and independent from political pressure. The new skills include understanding what governments and local authorities want in the broadest sense. To deliver that will entail the traditional skills of raising finance and assembling project management teams. Increasingly, however, knowledge of broader public policy goals will also be essential.

“A further twist for those operating across borders is supplied by differing regulations in home and host countries. Employment and environmental concerns are just two of the sensitive areas; another is where taxes are paid. The skill will lie in understanding not only what the law says in each jurisdiction, but also what public opinion might say is required. The spread of the internet and mobile communications means that businesses will increasingly operate in an atmosphere of transparency and free comment on what they do. This will affect commercial issues, such as product pricing, the business's impact on the environment and society, and its governance. Pursuing shareholder value in the context of the growing demands of ‘other stakeholders’ is becoming more complicated for several sectors, including financial services.”

**Charlie Alexander**, Partner, EY, UK

Another ominous strand in the protectionist scenario is growing evidence of resource nationalism. The announcement in 2010 of a proposed new “super profits” mining tax in Australia had a significant ripple effect around the world. Many mining and metals jurisdictions announced increases in taxes and royalties during the course of 2011-12, and many looked at Australia's action as commercial cover for proposed changes. In Namibia, all new mining and exploration has been transferred to a state-owned company.

Africa is not the only place to retrofit harsher terms on foreign, or non-state-controlled, operators. According to a recent EY study, *Business risks facing mining and metals 2012-2013*, resource nationalism is expected to be the number one issue facing firms in the mining and metals industries worldwide in the coming year.

## Finding the balance

Once again the issue is whether there is still symbiosis, with governments acknowledging that foreign capital and expertise will promote investment in return for a fair and predictable share of the rewards, or an impasse, with the country that has the resources neither allowing investors in nor having the domestic capability to go it alone.

With globalization intact, emerging countries, which have about 80% of the world's population, provide the engine of growth. This allows deleveraging to take place in a benign macroeconomic environment. So, while some countries experience painful adjustments, at least there are many growing markets to compete in. Financial services firms will see increasing opportunities as rising incomes create more savers, more buyers of insurance and more private businesses requiring funds for expansion, advice on transactions and risk management services.

Skills can be both exported to, and nurtured in, the target markets. The questions, as ever, are how much control will a foreign stakeholder be allowed? And how much of the profits made can the parent company deploy as it wishes?

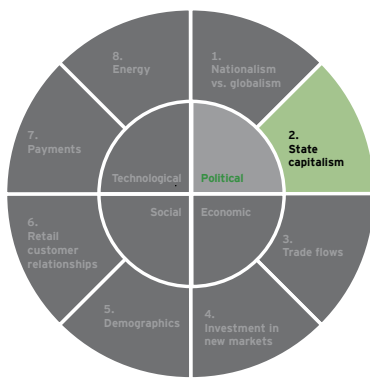
## What does this mean for the bank of 2030?

The competing forces of nationalism and globalism have both political and economic dimensions. Consequently, banks are faced with difficult choices in determining global strategy and footprint. These forces will also impact banks' ability to enter or exit markets inorganically and may place other constraints on factors such as ownership structure and repatriation of funds.

One way that banks may address this strategic conundrum is by placing their individual customers at the heart of decision making. Through holistic assessment of client-level product demand, profitability and risk-adjusted returns, the bank of 2030 may optimize its product portfolio and geographic footprint. The bank that is able to implement a rigorous and client-centric strategic analysis will underpin its success both through individually strong businesses that add value to clients and a high level of connectivity.

Another feature of the bank of 2030 is likely to be a strong structural vision, informed by regulatory, political and business requirements. It will use a range of legal and regulatory structures, including locally listed subsidiaries, branches and representative offices in a way that is capital-efficient and satisfies external regulatory and politically driven requirements. Operationally, banks need to consider the most appropriate structure that aligns to overall objectives, meets regulatory requirements and is economically viable. This may mirror the hub-and-spoke structure of distribution capabilities or include back office functions being run at a local, regional or central level. Finally, the structural vision will encompass regulatory requirements for resolvability in the case of a financial crisis and also provide flexibility for dealing with specific local rules. These local rules may require higher capital levels to be held and may trap capital and liquidity within a particular jurisdiction.

Outside the banking industry, negotiations between investors and resource-rich countries will continue to be complex, but as long as they take place, the financial services sector will continue to have an important role supporting and financing investment projects.



## 2. State capitalism

### A new force in global banking

State-owned enterprises are a dominant force in major industries, including financial services. A key question to be answered is how these will influence the bank of 2030.

In many countries, the years of the Great Moderation prompted a voluntary reduction of the state's direct involvement in the financial sector, whether through relinquishing ownership or relaxing regulatory controls. There was a general belief, stronger in some countries than others, that the financial sector was able to regulate itself, that the market would provide control, and that self-interest would ensure that risk was adequately managed. That hypothesis has now been demolished.

The financial services sector will, for the foreseeable future, see growing and intensive intervention and participation by the state and growing scrutiny by media, politicians and electorates. In some parts of the world, governments never subscribed to the hypothesis of the primacy of the private sector, ensuring that either through direct or indirect state ownership and/or by extremely tight control and regulation of the financial sector, the market was never given free rein. These jurisdictions now believe that events have vindicated their stance, and elsewhere it is rare to find, outside of the financial sector itself, advocates for a return to the status quo before the global financial crisis. Indeed, the number and increasingly global scope of scandals emerging after the crisis (including manipulation of LIBOR and other reference interest rates) has further diminished the credibility of self-regulation.

### The state-owned bank of 2030?

The state capitalist system is producing some powerful national champions across a range of industries, including banking. Certain of these enterprises have the commercial strength and resources to compete in global markets, although they may face resistance from overseas regulators who are keen to maintain a level playing field. State-owned enterprises also face challenges in maintaining competitiveness, avoiding cronyism and driving innovation. It seems pertinent to ask, therefore, whether the bank of 2030 will operate in a sector characterized by significant state ownership and influence.

Recent history demonstrates rapid growth of state-backed enterprises and includes numerous examples of commercial success. Certainly these national champions have played a major role in fueling growth in the BRIC countries and are giving Western governments pause to reconsider industrial policies, either to respond to the strength of these state-backed enterprises or to imitate them.

State-backed enterprises are influential in oil and gas, mining, metals and financial services industries, among others.

These industries each control valuable and scarce resources – for financial services, the key resource is financial capital – and the state's involvement can therefore be a significant accelerator by supporting the acquisition and deployment of these resources. Equally, however, an economic downturn may result in these becoming an unwanted draw on the resources of the state.

### Challenges

The confluence of political and commercial imperatives within a state-backed enterprise creates a necessity for skillful management, both within the state-backed enterprise and in the governance and control exerted over it. Indeed, some state-backed enterprises have government officers co-located with executive management to monitor and influence decision-making. Avoidance of political interference is a prerequisite for a successful long-term strategy. Some jurisdictions have segregated the governance and ownership of state-backed enterprises from other arms of the state to mitigate this, while others still enjoy the ability to be more interventionist.

For policymakers, ensuring that there is a level playing field between different sets of state-backed and non-state-backed enterprises is challenging. Trade forums and political unions, with the European Union as the most obvious example, seek to place controls on state support with a view to providing a fair and open market.

The European Union has punished state intervention during the global financial crisis by requiring firms that receive support to restructure and sell operations. As yet, we are a substantial distance away from an internationally consistent and level playing field, and this could be a source of major tension in trading relationships up to 2030 and beyond.





## Socially useful banking

"As they redefine their relationships with both state and society, it is inevitable that financial institutions will need to operate with much greater transparency and public accountability. Particularly in the Western economies, a fundamental debate about the role of financial institutions – especially banks – is just starting. This stems from the supposition that the maximization of shareholder returns cannot henceforward be the sole, or indeed the primary, objective of financial institutions. They will be increasingly expected to justify the contribution they make to society as a whole, and they will be expected to conform to broader societal norms and standards of behavior. The term 'socially useful banking' has sometimes been used to describe the activities that conform to this new model.

"The redefinition of the moral purpose of financial services will be a powerful theme in the years ahead, and conformity – or otherwise – will be vigorously and vociferously monitored by politicians, media, customers and regulators alike. The retail consumer in particular will exert a growing influence and pressure on the activities of financial institutions from both economic and social perspectives. The growing power of social media will equip the consumer with new tools to wield that power at both the institutional and industry level. Parallels with the growth of the green movement and its interaction with the energy and other natural resources industries will be instructive here."

**Richard Williamson**, *Managing Director, EY, Hong Kong*

## Promoting innovation

One criticism leveled at state enterprises is their lack of innovation relative to private enterprises. Historically, there are relatively few examples of state enterprises as true innovators. Countries with high state ownership of business have been taking deliberate steps to ensure that innovation is supported through the establishment of innovation zones and by directly supporting technology businesses.

Another way in which state enterprises (and indeed large private enterprises) can become more innovative is through acquiring smaller, more agile competitors. This quickly enables the enterprise to acquire teams of innovators, but the challenge then is to retain the conditions that allow them to flourish within a large organization.

## Upping the skill set

How do financial companies in the developed world compete with this? As it happens, they too are becoming used to state direction in their home markets. The UK's target for bank lending to companies is an example of this; so are US measures to aid distressed mortgage holders. This push for financial services to back public policy is not entirely new, even in the US – it is widely acknowledged as one of the causes of the subprime mortgage crisis.

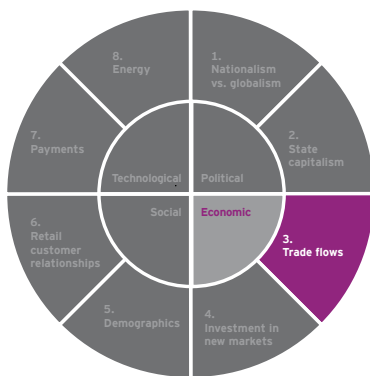
## What does this mean for the bank of 2030?

The bank of 2030 will be required to take account of the state to an unprecedented degree. While the precise regulatory architecture at national and international levels is still a work in progress, the incursion and involvement of the state in both the structure and daily operations of financial services – particularly banking – is inexorable and irreversible. The state itself, in many countries, will be a significant owner and operator of banks, which will pose interesting challenges about whether to manage them for the benefits of society or, more narrowly, for the interests of national coffers, and thus raise questions about the nature of the relationship with privately held institutions.

This involvement will have profound effects on the structures of financial institutions, their operations, their business models, their profitability and their governance. A process of reshaping financial services has only just commenced, will be long lasting and will have profound effects on its major institutions. Redefining the relationship between financial institutions and the state (and vice versa) will be one of the enduring themes and challenges of the coming decades.

While the prospect of close state involvement will fill many in the industry with trepidation, the definition of this new relationship will produce manifold opportunities for the innovative. There will clearly not only be classic transaction opportunities arising from the remodeling of financial institutions, either at the behest of the state or in response to new regulation, but also major strategic ones arising from the state's need to redefine its relationship with its citizens and its economy. In areas as diverse as pension and health provision, infrastructure, housing and economic development, resource-constrained governments will welcome partnership with institutions able to contribute and generate ideas, capital and operational skills.

The bank of 2030, if not a state-backed enterprise itself, will inevitably have large competitors and customers that are. Working effectively with these organizations will require a strong understanding of their objectives, motivations, strengths and potential weaknesses. The bank of 2030 should, therefore, equip itself with the necessary skills and capabilities to understand these new corporate powerhouses, to benefit from their scale and influence, while avoiding falling afoul of politically driven decisions and changes of management.



## 3. Trade flows

### A source of opportunity and volatility

So much is written about the growth in trade between developed countries and emerging ones, as part of the globalization story, that it is easy to forget that most trade flows take place within regions rather than between them.

The World Trade Organization (WTO) statistics for 2011 showed that:

- ▶ Europe had the highest level of intra-regional trade, at 71%, or US\$4.7t.
- ▶ More than 50% of Asia's trade was intra-regional.
- ▶ Nearly 50% of North America's was within the North American Free Trade Agreement (NAFTA) area (i.e., US-Canada-Mexico).

Intra-regional trade is growing strongly in emerging markets including within Asia, Africa and South America. In Asia, for example, it grew from 42% of trade in 1990 to 52% in 2011. By comparison, intra-regional trade has remained relatively flat in Europe and North America over recent decades.

As with population and GDP, the places with the fastest overall trade growth were in the emerging world. The annual percentage change in the volume of world merchandise trade in 2005-2011 shows that India had the fastest export growth rate, averaging 12.5%, with China next at 12%.

China was the world's largest exporter of merchandise in 2011, with some US\$2.1t of trade (13.2% of world exports), pushing the US into second position with US\$1.5t of trade. The US remains the largest exporter of commercial services, at US\$581b (14% of world trade). It is worth noting that the EU is not treated as a single market in the WTO's analysis.

### Scenarios for the next two decades

#### Increased globalization

In the absence of military or trade wars, or economic depression in any particular region of the world, the expectations would be for trade to continue to increase between the developed and the emerging world and, importantly, within the latter.

The established pattern is for the developed world to need access to cheap labor and raw materials, while the emerging world needs markets for its goods, as well as capital and skills to exploit its resources. As China becomes more expensive, places such as India and Southeast Asia, with younger populations and lower per-capita GDP, pick up the baton, to be followed by Africa.

Based on an optimistic view, resource-rich countries, including Russia, and in the Middle East and Africa, will become increasingly open to trade.

Growing businesses in the emerging world will require additional banking services for trade and investment in overseas assets, including acquisitions. And as the emerging world matures, with China leading the way, a growing middle class will create additional demand for both consumer goods and personal finance services. This will provide opportunities for exports of products and professional services from the developed world, and for the subsidiaries of multinational companies – both financial firms and their clients – to expand within these markets.

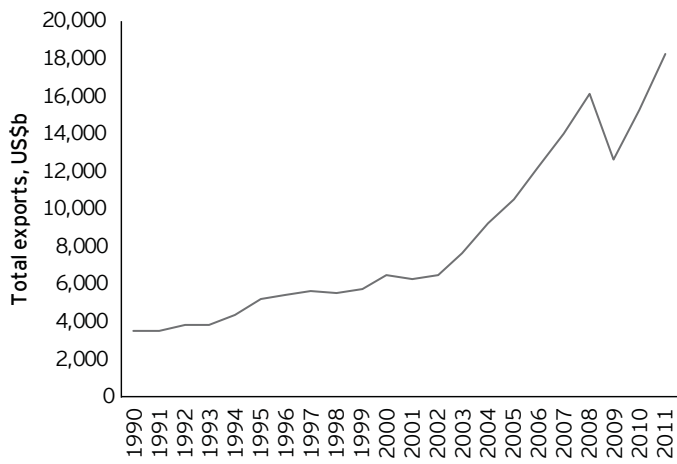
#### Zero sum or worse

The above scenario assumes that these countries remain stable (i.e., safe enough to do business with), that government policy toward external trade and investment remains positive and predictable, and that corruption is continually reduced.

The key to potential setbacks in global trade and investment lies in the reaction to the financial crisis. WTO figures show a drop of more than 12% in merchandise exports in 2009 (see Figure 3).

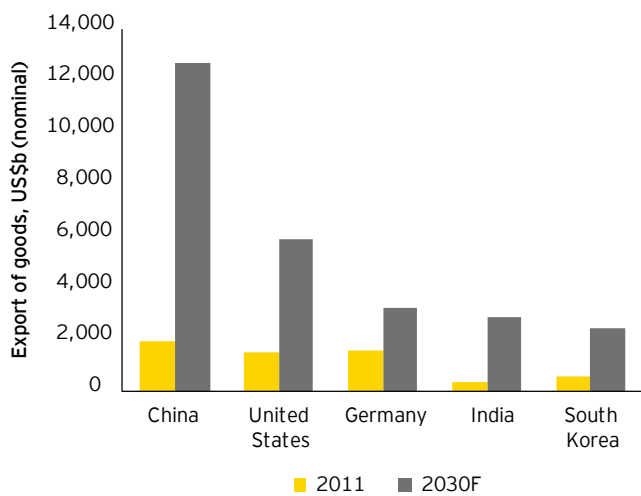
Merchandise exports bounced back by 14% in 2010 but then slowed again to 5% in 2011. Crucially, trade flows are far more volatile than GDP and tend to amplify its effects, growing much more strongly in upswings and turning negative at any sign of economic or political trouble. This explains why fears of protectionism are voiced so loudly in the downswings.

**Figure 1: World value of merchandise exports, 1990 to 2011**  
US\$b at current prices



Source: World Trade Organization

**Figure 2: Forecast of top five merchandise exporter countries in 2030**



Source: Oxford Economics



The Great Moderation, which coincided with the post-Cold War period of relative peace, provided an unusually benign combination of circumstances. So benign that they allowed the development of global imbalances, which effectively meant too much exporting by China, Germany and Japan and too much importing by the US and most of the rest of Europe, with too much debt being taken on by the consumer nations. If a rebalancing is desirable, can it be achieved without a dangerous slowdown in world trade, linked to a rise in protectionism and nationalism?

## Restoring competitiveness

A fall in the dollar and the euro, amplified for any country leaving the euro, would be another way to restore competitiveness. But this would not just be at the expense of living standards since inflation (and higher interest rates to curb it) would inflict damage on purchasing power. Devaluation would also impose losses on foreign holders of government and private sector debt, increasing interest costs, defaults and the frequency of recessions.

Wealthier countries would withdraw credit from indebted ones and redirect it toward areas of strategic interest. This could be good news for places like Africa but could also mean a new form of colonialism if the lenders wanted to exert more control over their economic interests. Where symbiosis between exporter/importer and lender/borrower goes into reverse, there would be less of a deterrent to emerging market governments wishing to tax or seize foreign-owned assets.

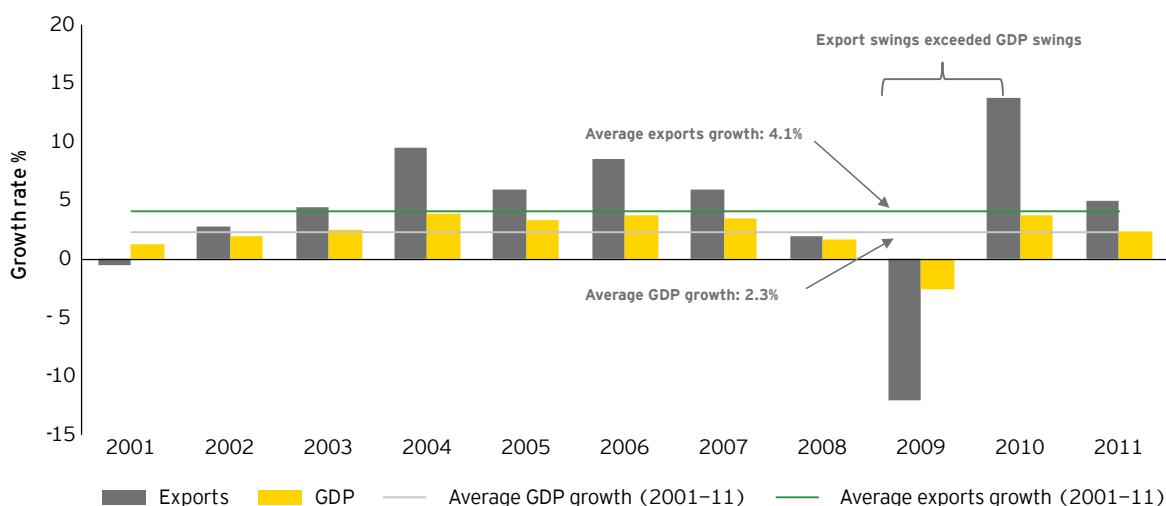
## Emerging world growth remains robust

In the emerging world, reduced dependence on Western markets, capital or skills, makes the travails of developed markets seem more remote. The virtuous circle of trade, investment, exchange of cheap labor for technical and financial skills, and rising living standards continues. The populous and increasingly wealthy countries of China, India, Indonesia and Nigeria will continue to increase in importance as markets for each other's consumer goods and personal finance. Trade between these markets will also increase as their economies mature. Only Western companies that have or can build established positions in these countries will benefit, and they will need to ensure they can repatriate an adequate proportion of profits.

## Global rebalancing

At a time when growth is at the top of many policymakers' agendas, there are potentially large gains to be obtained from increased international trade and reduced non-tariff measures (NTMs). Therefore, it would seem pessimistic and premature to assume that the trends prevailing during the Great moderation go into reverse. These advantages apply to established trade routes but will also increasingly apply to trade between high-growth and emerging markets. These gains provide a significant incentive for policymakers to avoid zero-sum thinking and continue to promote trade. They also provide a challenge as to how banks should respond to these new patterns of international trade.

Figure 3: Analysis of exports and GDP growth, 2001 to 2011



Source: World Trade Organization, World Trade Statistics 2012



State-backed enterprises, discussed earlier in this report, are positioned to play an important role in shaping international trade in the next two decades. The state also will often back the banks that serve these enterprises from their home market. These multi-dimensional relationships between the providers and recipients of capital introduce a new complexity to international trade. Global banks will increasingly be required to navigate these complexities in the next two decades.

## Core banking relationships

Despite changes to the global patterns of trade, many traditional principles of what makes relationships between corporations and their banks will still very much apply in the coming decades. In a 2013 EY report, *Successful corporate banking: focus on fundamentals*, executives interviewed emphasized the traditional principles of what makes business relationships work: mutual commitment, dedication and trust.

While the study highlights that executives are pleased overall with their current core team of banks, there are several performance indicators that banks need to address and improve to continue to effectively manage relationships with their corporate clients. When asked about service and product quality, executives saw a lack of consistency in the quality and delivery of services across geographies as their top challenge in working with banks. Typical dimensions of service quality include availability, approachability and professionalism of the people; knowledge of the business; willingness and ability to customize offerings; response time; and speed and efficiency of service. The ability to deliver across these dimensions of service quality, while also generating a satisfactory return, will be important determinants of which products banks chose to offer in which markets.

The challenge of meeting customers' expectations across a wide range of markets comes at a time when many global banks are rationalizing their international footprint and focusing on core geographies. Therefore, banks are faced with the questions of how to provide coverage efficiently, and how to balance the need for cost savings with investment required for growth. In certain markets, this may involve partnership of global with local or regional banks, with the compatibility of products and systems becoming an important consideration. Banks need to consider how best to combine the best in class local market experience with the advantages of a single global provider, recognizing that customers will manage multiple relationships to achieve their goal. This presents opportunities for both global and local banks.

## What does this mean for the bank of 2030?

Trade financing services are the lifeblood of international trade, allowing firms to finance and transact business globally. Banks that can attract and retain clients based on their international reach and value-added trade financing activities will surely be well positioned for success as trade grows in the future (potentially at a higher rate than GDP). But Basel III capital rules impose heavier capital charges on trade finance activities than banks have experienced historically. This has led some to argue that the rules are at odds with the fundamentally low-risk nature of much trade financing activity. Banks will be required to reassess their product offerings and pricing to ensure that they offer an optimal return on higher capital requirements.

The highly intra-regional nature of trade suggests high potential for the regional investment banking franchise and the growth of strong regional champions. Through excellent market knowledge, high service standards and deep relationships with corporate clients, the regional specialist models can perform strongly if targeted appropriately and operated efficiently (e.g., strong cross-selling disciplines). Regional champions are potentially strong partners for growing regional businesses, although these may eventually outgrow the available product set and geographic reach and require a more global banking solution.

One challenge in a potentially volatile era is banks' access to US dollar liquidity, as long as the dollar retains its status as the de facto international reserve currency. Dollar liquidity shortages caused major damage to trade-financing operations of European banks during the financial crisis, with US and Asian competitors sharing the benefits of this. Given the large quantities of intra-regional trade that take place, there is arguably a strong role for regional (rather than truly global) banks to play in supporting trade flows.



## 4. Investment in new markets

**The emerging will have emerged**

A new investment boom, which could last for decades, has started in the emerging world. Apart from continued construction in China, India and other countries experiencing industrialization and urbanization, both the US and much of Western Europe need to replace crumbling infrastructure. This generates a demand for capital that will outstrip savings rates as developing countries switch from investment to consumption-led growth. This will drive up the cost of capital.

This trend contrasts with a general decline in investment (as a share of GDP) in much of the West, which has been ongoing since the mid-1970s. The decline in interest rates in the developed world has encouraged households, particularly in the US and Europe, to run down their savings and to run up credit. Lower capital costs lay behind the increase in the price of assets against which they were borrowing.

The financial crisis has already sent some of these trends into reverse. Households in the US and Europe are deleveraging. By 2012, the US saving rate, which turned negative before the crisis, had rebounded to 6%. The value of a key asset – housing – fell across many Western markets.

The statistic that has yet to change sufficiently to restore incentives to save and invest is interest rates. Some academics, such as Carmen Reinhart and M. Belen Sbrancia, have revived the argument of “financial repression,” whereby government action keeps interest rates down. This helps the indebted, including governments that have run large deficits to combat the effects of the crisis. It also deprives savers of real returns.

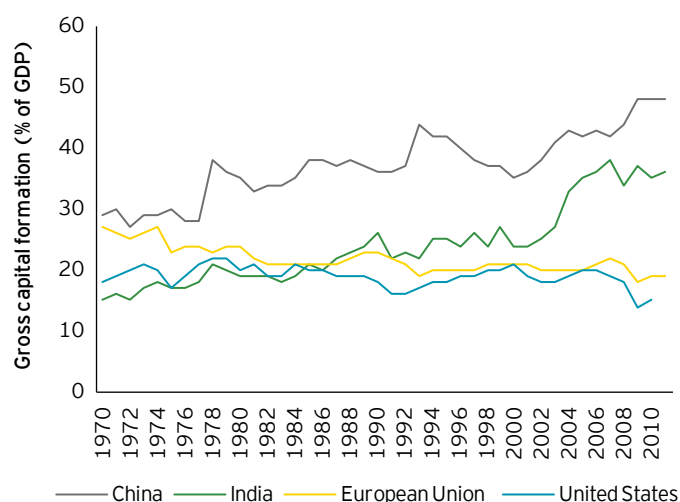
Factors that could start to lift the repression include the end of quantitative easing and other targeted monetary policy interventions in the US, Europe and Japan, and central banks raising interest rates to tackle inflation. Expectations of higher inflation, combined with a cessation of government bond purchases by central banks, would allow the yields on longer-dated debt to rise. Higher rates and a steeper yield curve would support the thesis of a new investment cycle. Policymakers will balance these objectives with the role loose monetary policy can play in supporting the health of the financial system.

## Newly emerging markets

By 2030, many markets that we currently refer to as emerging or growth markets will have reached maturity. Such references to BRIC countries will be long-since superseded by this time. In their place will be a new group of growth markets, many of which will be in Africa, Asia and Latin America.

By 2030, there will be significant role reversal between the emerging and the developed. In the former, individuals are expected to run down their precautionary savings as governments extend welfare safety nets, fueling consumption. In the latter, individuals are concerned that public spending cuts and unreliable private pensions will hit their standard of living, and so they will save more. They will seek better returns than those available from government bonds, especially where these “safe” assets are undermined by inflation or fiscal crises. So investment interest should increase in equities, infrastructure funds, private placements by local companies and exchange-traded funds offering baskets of securities in different sectors and regions.

**Figure 4: Analysis of gross capital formation as a percentage of GDP, 1970 to 2011**



Source: World Bank, World Development Indicators

## Case study: Africa

The emergence of Africa as a strong-growth region is underpinned by a host of factors, including strong FDI flows, increases in the quality and quantity of educational provision, the availability of natural resources and growing domestic demand. Bridging Africa's infrastructure gaps has been and remains a key focus area that will further enable growth and provide financing opportunities for the banking sector. It also remains a key challenge and opportunity for investors. Despite lingering negative perceptions, Africa is now becoming widely acknowledged as an important market to do business in.

Regional integration is critical for accelerated and sustainable growth. Creating larger markets with greater critical mass will not only enhance the African investment proposition, it is also the only way for Africa to compete effectively in the global economy.

### Nigeria

With a population today of 167 million people, and with rich reserves of oil and gas, Nigeria is well-positioned to take advantage of significant growth in coming years. By 2030 it will retain an extremely young and economically active population in contrast with many markets. It has been Africa's largest recipient of FDI in recent years, with these flows largely focused in the oil and gas sector. However, it is non-oil sectors that have been the drivers of recent growth, including, particularly, the telecoms, construction and retail sectors.

Nigeria is making great strides in many areas, with notable reform initiatives undertaken in the financial sector and tight fiscal and monetary management of the economy. A challenge that remains is to reduce reliance on the government sector. Nigeria has made significant improvements to its secondary school enrollment, but there is still potential to do much more.

Political risk factors relating to recent terrorist activity, and the potential for civil unrest between the Muslim north and Christian south, will serve as an impediment to some investors. However, with a large and relatively cheap labor force to draw on, many will come to the market and work alongside local authorities to address challenges.

The bank of 2030 can hardly afford to ignore the opportunities offered by markets like Nigeria. International banks will need to carefully calibrate products and services to suit the needs of clients within this market, but this tailoring is increasingly important in all products and markets. The challenge will increasingly become how to prioritize a new set of attractive markets.

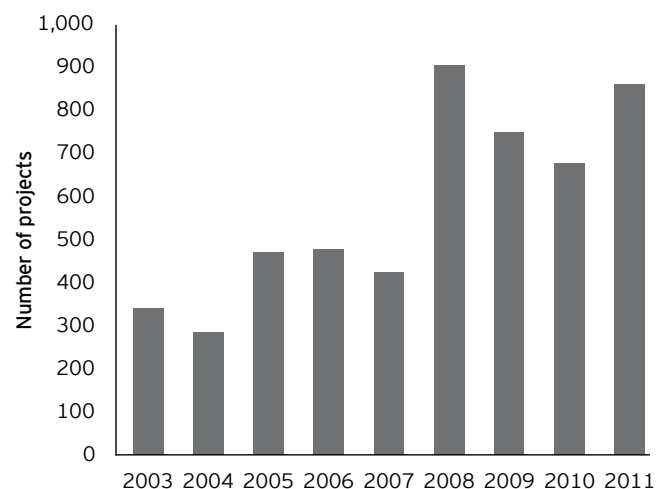
More information is available at [www.ey.com/emergingmarkets](http://www.ey.com/emergingmarkets).



"Nigeria is considered by many people to be one of the most exciting emerging markets in the world today. Oil remains a major draw card for investment and remains integral to the economy. However, consistently high growth rates, together with the largest population in Africa, is attracting investment into a number of other sectors, notably telecommunications, financial services and consumer products. We are very positive that these trends will continue."

**Henry Egbiki, Partner, EY, Nigeria**

**Figure 5: Analysis of Africa FDI project numbers**



Source: fDi Intelligence, EY analysis





## Stakeholder management

“In the increasingly globalized world of 2030, high levels of connectivity and communication will be essential. Bank boards, those charged with strategy and CDOs will have to communicate not only with internal stakeholders around the world, but increasingly maintain a strong understanding of the perspectives of wider stakeholders, including shareholders, regulators and politicians.

“CDOs are already working in an environment of stronger economic capital frameworks where they partner with strategy teams in advising the board. In some organizations these functions share a common management structure, while in others, the CDO function reports into finance, with both models providing different strategic advantages. What is essential is that the chosen structure aligns to the organization’s broader management structure and strategic imperatives. It is key that the joint team can develop strong business cases that support the board’s objectives and, if necessary, can be used to put forward decisions that gain shareholder support.

“Banks will also need relationships with alternative capital providers, including private equity and sovereign wealth funds, as these pools of capital gain increasing prominence in the future. It is key to understanding their motivations, activities and preferences in order to work effectively with them.”

**Nadine Mirchandani**, *Partner, EY, US*

## What does this mean for the bank of 2030?

The potential is clear, both from supporting investment activity, and also the inevitable rebalancing of economies from being export-led to consumption-led. Financial firms that want to compete in emerging markets have a number of choices, but entry by outright acquisition is the most sensitive. Even the US, with its Committee on Foreign Investment in the United States, does not allow a free-for-all in cross-border M&A. Much depends on the sensitivity of the sector, and banking tends to be political because of the state’s interest in the role of credit in promoting growth and as guarantor of deposits.

Where multinational banking groups have been assembled, the trend over the next few decades might be to increase local control through the listing of national subsidiaries. While the initial motive might simply be to raise money, if federated structures work – as they do already for some financial groups and professional services firms – then the sector might mirror the multipolar world envisaged for political power, with networks built up through historical links and opportunistic stake-building. The route to global structures with degrees of local autonomy is being eased by global regulation of bank capital, trading and accounting, and by contingency plans for cross-border resolution of systemically important banks.

Short of controlling stakes, partnerships or joint ventures can be sought with local firms, which may be seeking capital and expertise to assist them to grow. Organic growth of a division in an emerging country is time-consuming but might create more value than paying a premium to acquire an incumbent. Regional subsidiaries can become accepted as domestic players.



# Regulators' view of transactions

Regulators will continue to have a major influence on M&A for financial institutions in the coming years. Financial sector M&A contributed significantly to the failures of banks in many markets during the global financial crisis. However, it also facilitated the rescue of others and was the means by which many of the European Union's state aid remedies were dispensed. This illustrates how M&A can be both a solution to many of the challenges facing the banking sector if undertaken effectively and a source of major risk. In an era of increased scrutiny, it will be more essential than ever to demonstrate a robust business strategy and transition plan for proposed M&A when building the bank of 2030.

## Necessary change within the sector

Regulators recognize that the banking sectors of many markets are in need of structural reform, with large numbers of small and inadequately capitalized banks. Merged entities, as long as integration is undertaken effectively, can benefit from capital efficiencies.

In-market M&A has historically provided banks with significant cost synergies that represent a boost to profitability and therefore, ultimately, to capital. Additionally, M&A can provide banks with important revenue opportunities, through providing new products and new markets.

These changes all represent positive developments that regulators would be supportive of if properly managed, but the case needs to be made compellingly and with a clear explanation of how it will be controlled.

## Entry to new markets

Building the bank of 2030 will involve, in many cases, acquiring businesses with new capabilities and in new markets, and therefore working with regulators in the home and the new market. While banks have relationships with their current regulators, new relationships will need to be formed quickly to progress with the deals. Banks would be well advised, therefore, to plan well in advance to build relationships with key regulators. The bank of 2030 will need to crisply and clearly articulate its rationale for market entry, supported by robust business plans and evidencing that it can conclude the transaction with minimum risk of disruption. This will be all the more effective if banks have an ongoing dialogue with relevant regulators.

When exiting markets, banks also need to be mindful of the standing of potential buyers in the eyes of regulators, or risk potential derailments to the sale process if required approvals are not achievable.

## Effective governance

Effective governance of M&A is an important control to mitigate the mistakes of the past. In the Walker Review of Corporate Governance of the UK Banking Industry, Sir David Walker highlighted the potentially “heady mix of enthusiasm for the mooted transaction on the part of the CEO and the investment banking adviser,” which a financial institution’s board should be mindful of. The report recommends that, for strategic pieces of M&A, the board risk committee should advise the board to ensure that due diligence is undertaken, focusing on risk aspects and implications for risk appetite tolerance.

## Conclusion

Banks wishing to undertake M&A need to work closely with regulators to establish the robustness of their plans and the impact these will have on the sector. By doing so, the bank of 2030 can be built while avoiding repeating the mistakes made by many during the global financial crisis.



### Lenses for assessing M&A

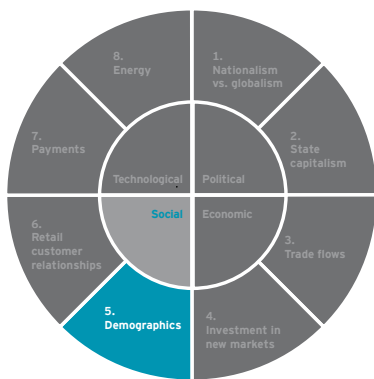
“The choice of lens will have a major impact on the perceived risks involved in an M&A deal and the level of mitigating action required. The kinds of questions that impact a bank’s standing in the eyes of its regulators include:

- ▶ What is the transaction’s impact on systemic risk?
- ▶ What is the execution risk of doing the deal?
- ▶ What is the capital position of the combined entity?
- ▶ How well prepared is the acquirer to effect a timely and well-managed integration?
- ▶ How is the business model impacted in terms of concentration risk and diversification benefits?

“These questions contrast with the strategic and financial measures that banks use to assess proposed M&A, enabling it to generate return on investment (ROI) over time (i.e., to create value from the deal).

“However, understanding and managing both aspects will be essential to ensure that M&A ambitions can be realized in building the bank of 2030, and regulators will generally be happy to see smaller, weaker players being consolidated by larger, stronger ones.”

**Tom Huertas**, *Partner, EY, UK*



## 5. Demographics

### Serving an older, more urban generation

By sheer population size, the emerging world dwarfs the developed world by about 5:1. United Nations' forecasts are for the overall population to reach about 8.3b by 2030 – 1.3b more than at present – and for the (currently) less-developed regions to make up 7.0b of the total. Africa and Europe represent opposite ends of the spectrum, with the former projected to increase by about 36% between 2000 and 2030 to 1.5b, while the latter grows by merely 3m to 741m. North America continues to grow, with help from immigration, but at about 402m in 2030, it has less than 16% of Asia's forecast tally of 4.9b. China's population is estimated to peak in 2030 at 1.6b while India's is forecast to keep growing to 2060, where it will peak at 1.7b.

GDP growth rates are also tantalizing. Whereas global population is forecast to grow by about 17% by 2030, a conservative estimate of GDP growth of 2.5% a year would expand the world economy more than 50% and every forecast assumes that the developing world will expand at an above-average rate.

But per-capita wealth has always been much more important to the financial services industry. China may overtake the US as the world's largest economy by the end of this decade, but it is much further behind in terms of GDP per capita. On this measure the US had more than US\$48,000 per person, according to IMF data in September 2011, while China had little more than a sixth of that. Even under an exaggerated assumption that China's wealth per head will rise at 10% a year while the US stagnates, it would take until 2030 for the former to catch up.

### Urbanization

From the banking industry's point of view, a key development trend, which goes hand-in-hand with rising wealth, is urbanization. This provides access to concentrations of potential customers seeking credit to buy cars and homes, which they will wish to insure. These developments go hand-in-hand with a greater demand for financial planning – for their children's education and their own retirement.

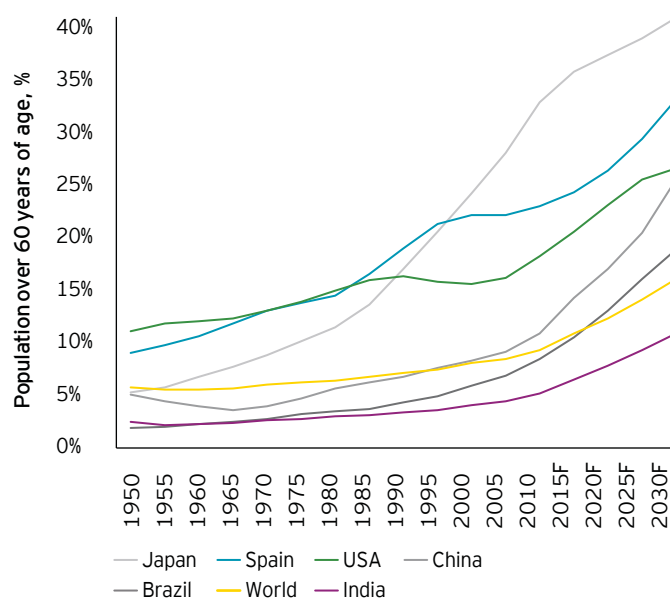
### Aging populations and the impact on wealth

Another strand in the demographic debate is the proportion of the adult population that is in paid employment. In the developed world, concern has mounted about the dependency ratio, which compares the number of workers with old/young people who do not work.

According to the United Nations, the 15-64 age group is the demographic window. Countries with a large working-age population and relatively light dependency burden have "the demographic potential for high economic growth." Its figures suggest that the percentage of the world population aged 60 or over will increase from 11% in 2010 to 17% in 2030. In addition, the overall size of the 15-64 age group will continue to increase for most of the 21st century but has already begun to decline in some developed countries.

Europe reached that point by the end of the last century, while Japan is, by some forecasts, set to see the 15-64 age group fall from 87m in 1995 to only 69m in 2030. In the US, baby boomers born in the two decades after World War II have started to retire. Africa's working-age population, by contrast, is set to nearly triple in the first half of this century to about 1.2b – more than three times Europe's projected number.

Figure 6: Analysis of population over 60 years of age, major countries



Source: United Nations, Department of Economic and Social Affairs, Population Division (2011). World Population Prospects: The 2010 Revision



An urgent question is whether the working population can be expanded by raising the participation rate. The World Bank's employment ratio is calculated as a percentage of those over 15 who are in work, although we note that many young people will continue in education past this age. The variation (2010 figures) among developed countries is revealing. In the EU, the ratio ranges from Norway and the Netherlands (64% and 62%, respectively) to Italy and Hungary (45%). The US was on 58%. This compares with the relatively high percentages in work of many emerging economies: China, 71%; Ethiopia, 80%; and Brazil, 65%. In contrast, India was only at 54%; South Africa, 39%; and Turkey, 44%.

So countries with ample capacity to expand their workforces are spread across the globe and are both more and less developed. The question is how might this happen? The answer is likely to include a combination of economic growth, reforms to labor laws and practices, and education policies that provide the skills needed for the future.

But there will also be further increased productivity – and wealth creation – through technological advances and automation. Under a benign scenario this increases wealth, which can be distributed to the general population either through hiring their services for non-automated work or by giving them investment returns.

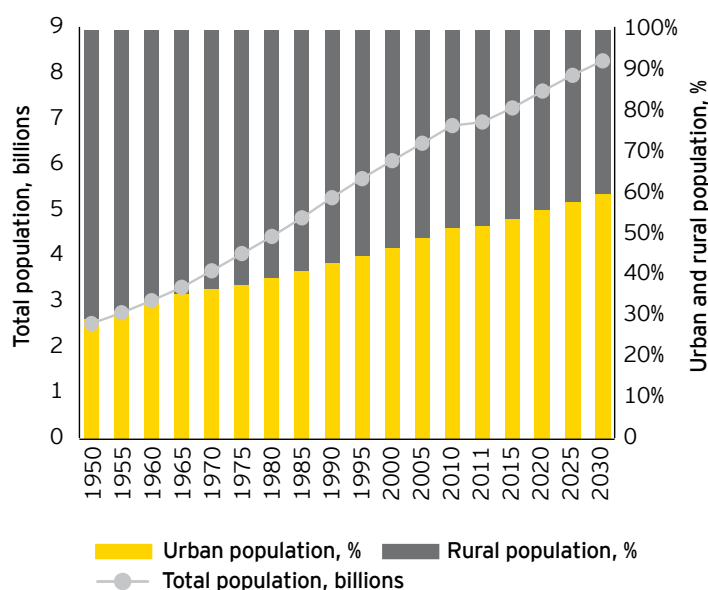
## Access to services

The bank of 2030 will provide access to banking services to both men and women in many countries where these services are offered only to men today. Microfinance institutions have highlighted the potential to offer financial services in rural communities, and some have focused on lending to women. The success of these models supports the case for banks to move into these markets over time.

Access to banking services is heavily influenced by a woman's social status in many parts of the world today. These barriers will be gradually eroded as the education and incomes of working-class people increase.

Developments in mobile banking are also revolutionizing access to services in many parts of the world. According to a 2013 report published by EY and Knowledge@Wharton, *Mobile Banking - Financial Services Meet The Electronic Wallet*, this technology is reshaping economies by introducing the financial system to millions of unbanked consumers. For people in this category, text-message-based capabilities to store and move money have proven to be life-altering services. In a number of markets it is telecoms firms, not banks, that have so far led the way.

**Figure 7: Analysis of urban and rural population, worldwide**



Source: United Nations, Department of Economic and Social Affairs, Population Division (2012). *World Urbanization Prospects: The 2011 Revision*

## The bank of 2030 as an asset manager?

Demographic trends, showing the emergence of an aging population, naturally lead to questions about the pension arrangements for this group. These financial products are largely provided by the insurance and asset management industries. With banks currently still being the owners of some of the world's largest asset management businesses, they are therefore closely tied into this question.

Banks and insurers are currently reassessing core activities under the pressure of regulations (Volcker, Basel III, Solvency II) and the need to de-lever balance sheets. In part, this is leading banks to realize the importance of their asset management business as having low capital-intensive and often favorable cash flow profiles. Asset management businesses are, therefore, seen as valuable parts of their franchise, which will be retained as part of the bank.

These same factors also make bank-owned asset managers relatively easy to sell to raise capital. While divesting captive asset managers won't, for the most part, solve banks' capital challenges overnight, they remain a potentially important source of capital, particularly if a clean sale to a major independent asset manager or private equity house could be negotiated.

More broadly, the asset management world is exhibiting a trend towards polarization of high-alpha products (sometimes known as niche) and low-margin, beta products (sometimes known as standardized).

High-alpha products or products with low market correlation are often associated with high margins and high production costs (e.g., skilled fund managers). These product types often operate within a partnership model that also assists with brand recognition. For more standardized products, such as beta products (e.g., index trackers) or low-cost alpha products (e.g., ETFs), the market is typically characterized by low fee rates but with huge economies of scale to ensure low-cost profitable production. For this market, distribution power is key to ensuring revenue volume. Investors and intermediaries are taking a much more highly segmented view of the asset management universe. In this new environment, inflow concentration is soaring – a number of mainly independent players are winning and separating themselves from the rest, particularly through strong investment performance.

The retail distribution landscape is becoming much more open and competitive. Given the open architecture framework in place in many markets, a high focus is required on quality of service. In order to build differentiation amongst distributors. In order to revive their business models many captive players need to take decisive action that may include developing a clear strategy on distribution channels, undertaking product range optimization, reducing complexity of their operations and enhancing selection/advisory capabilities. If it can rise to these challenges, there is every chance that the bank of 2030 will also be a major player in asset management. If it cannot, then it is likely that these operations will have been divested long before that date.



## What does this mean for the bank of 2030?

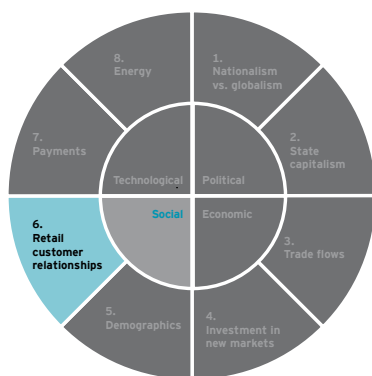
For the financial services industry, this raises several issues. So far, it has benefited hugely from the wealth of countries that can afford to have people living for, in the case of the US, an average of 12 years in retirement. This has been achieved on the back of both large pension funds and pools of private wealth, which both need to be managed, and taxpayer-funded entitlements. Private sector savings have been recycled into capital markets to buy corporate bonds and equities and the government bonds that fund the welfare state.

There are potential opportunities to provide new services to an aging population. These include improving offerings to savers and better enabling the elderly to run down their accumulated wealth and support a quality of life they are accustomed to. Population trends are some of the most stable and reliable of long-term predictions and therefore provide a relatively firm base for future planning.

Mobile banking provides an unprecedented opportunity to reach new customers in the unbanked population. Banks know that mobile customers cost much less per transaction, but the incentive is much broader than cost. Organizations involved in mobile banking profit not only from the transactions themselves, but also from all the information that mobile commerce generates about consumers and their preferences.

Many developing and resource-rich countries already have large institutional investors established in the form of sovereign wealth funds. As social safety nets are installed in places such as China, government and employer-based funds can increasingly be put to work to build pension and health-care reserves. This would free up private precautionary savings for consumption and fuel the development of capital markets and international investment.





## 6. Retail customer relationships

### More personal, greater trust

The interaction between organizations and their customers is changing fundamentally. For retail customer relationships, where we have chosen to focus for this theme, change is being driven by a variety of social and technology trends. It would be premature to predict the death of many established virtues, such as personal service and face-to-face interaction. Through the combination of rich data, smart analytics and innovation, the next two decades should represent a renaissance in the relationship between banks and their customers.

Retail banking is changing, with customers taking more control of the relationship. They are changing their bank more often, buying products from more than one bank and demonstrating a preference for tailored products and services. By 2030, relationships between customers and their banks will look very different from today as technology provides ever-greater possibilities to broaden and deepen relationships with customers.

### Trust and bank culture

Trust in banks, in many parts of the world, has been eroded by the financial crisis. A range of reasons underpin this trend, but there has been particular concern in relation to the culture and values within banks. This includes associations of a culture of greed and bankers who do not have customers' best interests at heart. Mis-selling scandals have also placed a heavy financial cost on the industry in relation to a range of past misdemeanors.

Strong personal values of employees are the bedrock of effective governance for a bank, as well as the foundation for trusting relationships with customers. There is an increasing view, in many quarters, that these values should include responsibilities both to customers and to society as a whole. The bank of 2030's values will be understood and respected through the organization (as well as by its regulators) and will be linked to the performance management of its staff.

### A virtual-only retail world?

The rise in the popularity of internet shopping may lead some to question the future for the physical retail experience more broadly, particularly in parts of the world where this has not yet become established. Certainly, over the past 50 years or so, there have been many major changes to the shopping experience, including department stores, large "category killer" box stores and the development of shopping destinations.

In the future, the retail experience may increasingly begin online, through research of product ranges and price. It will use technology to provide images of the products, the ability to consult with friends and family, and sophisticated recommendation engines to suggest further purchases. It will also remain in the physical domain for selection of products where the look and feel is important, or where there is an associated sensory or social experience.

The physical bank branch has long been a cornerstone of the retail customer relationships in many markets. It has evolved over recent years to reflect changing customer requirements for advice and advances in ATM technology. Whether customers will continue to value the branch so highly, or use it in the same way as they more fully understand the cost of its provision, is an important question for the industry in the face of increasing online competition.

### Personalization in banking

Another important dimension is the value customers place on personalization of services. Most bank customers currently do not feel that products and services are customized to meet their needs. Only 44% of respondents to EY's 2012 Global Consumer Banking Survey stated that they are provided with tailored offerings, and the majority would be happy to provide more personal information in order to receive a more tailored service.

By 2030, banks will offer a highly personalized offering as standard, with transparent pricing of different options and services levels. The development of these personalized services may, in some instances, be undertaken by business partners or customers themselves. By working with customers, the co-creation of products and services is possible. This has strong potential to speed up development, build loyalty and cut acquisition costs through customer advocacy.

Progressive outsourcing has the potential to be far-reaching within the banking industry. For some products, the whole back office function may be more efficiently undertaken by a large technology company or data center provider than the bank itself. In this case, the bank will become a hub for advice, marketing and product design, while processing functions are outsourced.



## Trust and customer relationships

“The global financial crisis has negatively impacted trust in banks, particularly in western Europe and the US. Banks are working hard to restore this trust but face increasing competition from non-bank brands, which are using their brand power and technology capabilities to enter the financial services arena. In the face of this competition, however, it is worth noting that banks continue to be most trusted providers of core banking services.

“Trust is vitally important for providers of financial services for many reasons. Particularly pertinent for the retail consumer is that he or she tends to rely on advice, rather than being able to test out various products and services, in making his or her buying decisions. Very often, purchases are large and infrequent (such as obtaining a mortgage), which makes switching between providers impractical.

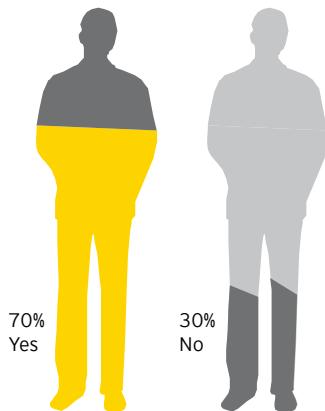
“Restoring trust in the banking industry is a challenge not only for banks but also for regulators and politicians. Organizations are focused on a broad set of measures to achieve this, including culture and values; governance structures; prudential rules and macro-prudential approaches; conduct-of-business rules; structural reform; and more intensive supervision. These changes represent major reform of the sector and should significantly improve trust once established.”

**Tom Bull**, Senior Manager, EY, UK

## Structured and unstructured data

Customer transactional data provides a rich repository for value-added services. Services like budget monitoring tools, or targeted promotions and advertising, could be tailored using this information and delivered in real time. The concept of big data, referring to the use of the large volumes of data outside the usual systems, or outside an organization, is already becoming increasingly important for financial institutions. This originates from mobile phones, social media sites and meteorological observations, among other sources, but requires specific skills and technology to analyze. If harnessed correctly, it will be highly valuable in selling, pricing and underwriting products.

**Figure 8: Percentage of customers willing to provide their bank more personal information in order to receive a more personalized service**



## Product information

A customer's physical location will also provide opportunities for interaction between the bank and customer. Augmented reality applications (which combine images captured by a camera with additional data) are an early example of this. Customers may soon come to expect their bank to know their physical location and respond accordingly. Lastly, banks will be far more explicit in their measuring of customer value by 2030. They will develop loyalty mechanisms that deliver targeted rewards to maximize and protect wallet share. These rewards will be much more immediate than those delivered by banks today.

Delivering on this potential will require continued major technology investment and a much greater level of integration between systems than is typical today, but also an increasing need to work with technology providers and innovators in customer analytics.

## Social media

Social media is playing an increasingly large role in the interactions between service providers and their customers. These interactions take many forms, and banks need a well-developed strategy for this channel. They provide an important listening mechanism for banks to understand the views of customers. In some instances this may also require a rapid response, particularly if errors are being highlighted or misleading information is being disseminated.

Friends and family are today's most commonly used source of information on financial products, and online communities are increasingly becoming an important source. These communities effectively become an extended network of friends and family who can provide advice on providers and services. Banks need to quickly embrace the opportunities provided by this development and mitigate the risks.

Banks can also use social media much more proactively to create conversations with customers around particular products or the brand more broadly. Social media can be used to create a buzz around new product launches or to drive traffic to a certain website or promotion.

Embracing these techniques will provide potentially major benefits to banks above and beyond more traditional marketing activity.

## What does this mean for the bank of 2030?

Many customers still prefer to visit a bank branch for transactions or product purchases that are complex. For simple transactions, the internet is now a strongly preferred channel across all age ranges and appears set to remain so. A natural development for banks is that individuals are incentivized to go through a preferred, cost-efficient channel for their specific interaction. These approaches will be widespread by 2030. Customers will expect seamless integration of voice, branch and internet channels, along with new channels that have not been invented yet. This is likely to include channels that integrate with those of key partners (e.g., retailers).

Banks will use deep data analysis and new techniques for cost-efficient experimentation to provide high levels of customization. The bank of 2030 may look, from the outside, like hundreds of banks, each with a specific product offering that suits a segment of customers. Customers will then be able to self-select which segment best matches their personal requirements. Movement between segments will be dynamic, due to life events such as career changes and family developments.





# Integration in the future

The bank of 2030 will be built both organically and through acquisitions. Historically, the failure to effectively or fully integrate acquired businesses has been a key driver of M&A in the banking sector (along with other sectors) failing to create shareholder value. This failure has often, in the short term at least, resulted in a loss of customers and key talent. Perhaps more importantly from the shareholder value perspective is that it has also left layer upon layer of legacy infrastructure in many organizations and therefore a range of hitherto untapped synergies.

This historical failure to fully or effectively integrate acquisitions has significantly impacted the round of divestments that banks have been looking to make in recent years. Historical acquisitions that were never properly integrated have often been identified as candidates for disposal, and those that were partially integrated have required complex separation plans and transitional services agreements to be put in place in order to facilitate a timely and efficient exit.

The design and consistent application of an effective integration process will therefore be a vital component for building the bank of 2030 where this takes place through acquisitions. More than ever before, banks will need to ensure that a clear integration strategy is set and adhered to and that optimal value is realized from any acquisitions undertaken.

## Shifting transaction landscape

For large transformational deals, organizations have little option but to undertake a comprehensive integration. In many Western markets, it is less likely that banks will undertake transformational M&A in the foreseeable future due to stronger regulatory oversight, decreased risk appetite and the greater difficulty of raising capital. Deals will more likely be in-market, consolidating broadly similar operations into the bank. In these markets, fully capturing the available cost synergies (and hence maximizing the return on investment) will most often be the driver of deal value. Focused growth- or diversification-driven acquisition strategies, as favored today by certain Middle Eastern banks, among others, may also be a feature of the landscape.

Many banks have experienced failed attempts to sell businesses during the financial crisis. This may present an opportunity to revisit the level of integration of these businesses in the group, with a view to either maximizing revenue and cost synergies or increasing the ease of separation for future disposal.

## Impact of regulation

Regulations implemented since the financial crisis will impact the way in which integration is undertaken. For example, recovery and resolution plans should improve the ability to separate businesses, enabling them to be sold if the bank needs to raise capital or ultimately be resolved. Depending on how fully banks develop these plans, they have the potential to mitigate a number of common carve-out issues impacting transactions in recent times – for example, segregation between business lines, shared-group third-party contracts and robust commercial arrangements for intra-group services. This advanced planning should assist any carve-outs and subsequent integration of acquired businesses. Additionally, this may avoid halfway house integrations, as business units either need to be resolvable as part of the bank's critical economic functions or sellable as a recovery action.

Regulatory scrutiny of proposed M&A will focus more objectively on integration plans in the future, particularly where this impacts critical economic functions such as payments infrastructure. The impact of integration on the customer base is also of increasing interest and this will likely be the key point of discussion for the bank of 2030 with their regulators when undertaking M&A.

## Voice of the customer

The increasing drive to put the customer experience at the heart of integration planning will continue and, for the bank of 2030, a cross-functional team dedicated to managing the customer will sit at the heart of most integration programs.

There will be two key drivers of this change. The first is the increasing dominance of customer self-service channels as a means of access. The shift toward these channels mean there is immediate transparency of any changes to the customer proposition or glitches in the migration of data from one core banking system to another. The second is the increasing challenge of customer retention, particularly due to a drive by regulators for increased simplicity and efficiency in the process to switch providers. In some jurisdictions there is an ambition for this process to be same-day. Customers will therefore be more mobile than ever.

The slightest mistake during the integration process will, therefore, have much more immediate implications for existing revenue streams, thereby increasing pressure on the bank of 2030 to design and execute a smooth transition for the customer base.



## Deal integration timetable

"Core banking and related systems are getting newer, simpler, more flexible and easier to integrate. Integrations will increasingly be taking place in domestic markets. The challenges and key decisions of integrations will remain largely as known today. There will be significant numbers of people available in the banking market with integration experience. Will acquisitions, therefore, be integrated more quickly and at lower cost in the future?"

"Two to three years is often seen as a typical stated length of time for the full integration of an acquired bank. However, when considering transformational M&A, it is increasingly recognized that a period of business transformation and simplification will follow major systems integration, and, therefore, it may take a bank many years more (up to 10) to fully revise its business model following a piece of transformational M&A."

"In all likelihood, integrations will not be any quicker or materially cheaper in the future, because the fundamental challenges of integrating people and cultures, and harmonizing customer propositions and IT will remain and in some ways present a greater risk with the immediacy at which customers can transfer their allegiance to another bank. But, by focusing on core markets and adopting integration best practices, the bank of 2030 should be more effective in generating positive returns from its acquisitions."

**Michael Wada**, *Executive Director, EY, UK*

## Managing complexity

The complexity of integration is, in general, largely driven by the degree of alignment of the range and features of products, channels and services on offer within the respective customer propositions, and how the bank chooses to address harmonization. It may also be significantly impacted by the international and organizational complexity of the institution in question. A key question, then, is whether this complexity increases or decreases in the future?

For many organizations, international complexity has been decreasing in recent years through exiting non-core markets, legal entity rationalization programs and increasingly stringent local capital and liquidity requirements. For certain products, the trend is toward simplification as well, driven particularly by increased regulatory scrutiny. These trends toward simplification (alongside a broader trend for cost reductions) may also be drivers of less complex core banking and related systems in the future.

The use of third-party service providers typically complicates integration activities by bringing additional parties into integration planning and negotiations whose objectives may not be fully aligned with the acquirer's. Additionally, as the trend toward third-party hosting and management of infrastructure, and cloud computing continues, the ease of integration may be influenced by whether the acquired entity shares the same provider as the bank itself.

Whoever supports the processes and systems that enable them, this challenge of harmonization will largely remain the same. The most successful strategy will likely remain to fully align the target to the acquirer's product suite and build back in any lost product features over the ensuing years.

The bank of 2030 is also less likely to be tied to a single outsource service provider because the regulator requires robust step-in plans in case the third party fails. The more third parties that are involved in integration, the more that progress is not directly in the hands of the bank(s) and therefore the more timelines may be put at risk.

## Culture and people

Of course, the culture of banks has been another major area of focus since the global financial crisis. Banks are increasingly focusing on culture as a core component of their risk management framework. Historically, banks have had a very mixed record of integrating cultures following an acquisition, with notable examples of staff retaining allegiances to legacy businesses and brands for years or even decades in some instances.

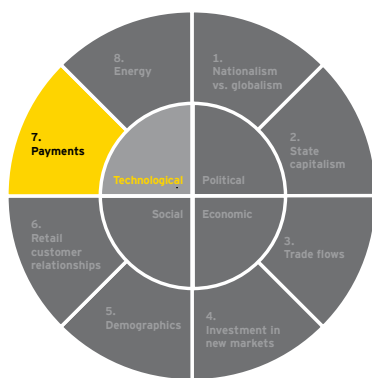
The culture, organization structure and reward packages of banks will continue to be different from institution to institution because they are a key means of employer differentiation. They will remain as key focus areas and challenges to align smoothly, at speed and without incident. Key staff retention will remain a leading agenda item for any CEO or management team.

When acquiring innovative businesses, including those that provide new capabilities and technology to the organization, banks should consider how best to preserve cultural attributes that allow creativity to flourish. For example, there may be limits on extent of integration in order to retain certain characteristics of a start-up business rather than a large corporate organization.

## The conundrum for the bank of 2030

In the last decade, one of the key drivers for a successful major banking integration has been the definition of a clear strategy based on the principle that the target becomes fully aligned to the proposition and operating model of the acquirer. This has typically required the acquired customers to accept some temporary (or in some cases long-term) adverse changes to their products after the integration, while the acquirer works to optimize their systems and processes and build the lost features back in.

But will the bank of 2030 be able to take such an approach, when customer expectations are high, their mobility is greater than ever and there are fewer meaningful barriers to switching allegiance to a new bank? Ensuring a smooth customer transition will be more critical than ever in the coming decades and could start to counterbalance an acquirer's ambition to effect a rapid integration.



## 7. Payments

### New markets and new models

Technological change is occurring at such an extraordinary pace that many developments that will occur by 2030 are unimaginable today. These developments will impact the speed and flexibility with which products and services can be provided to customers, as well as reducing the cost of providing them.

In some areas, significant fragmentation of the value chain may be expected, with technology and business service providers taking on roles currently fulfilled within banks. In others, disruptive technologies may change the landscape, or banks may choose to acquire and deploy these technologies for themselves. Regulation will play a pivotal role on the extent to which new solutions are able to develop and the speed with which this occurs. These changes could fundamentally reshape many of the markets in which banks and their customers operate, create new markets and render others obsolete. Payments are one area where these trends are already beginning to take shape.

#### The rise of PSPs

The financial services sector, including credit card providers, faces a classic challenge in payments over the next few decades: to try to protect its privileged role as the provider of payment services or to acknowledge that this is now an open competition. The entry of various non-bank payment service providers (PSPs) means that the latter is already the case.

It is easy to forget, as the number of PSPs proliferates, that the money is still predominantly moving from one bank account to another. How often is an intermediary needed? Electronic money transfers, including currency conversion, will increasingly be automated and directed by customers from their own accounts. PSPs may specialize in retail payments or combine payments with currency exchange or distributing the goods paid for.

Banks are obviously capable of embracing technological innovations that reduce transaction costs. The question is whether they will do so when the initial result is tighter margins. There will also be opportunities for partnering with non-banks, with the regulated financial firm specializing in the security of funds or guaranteeing the creditworthiness of counterparties. White label solutions are a likely approach where technological innovation is required (and the market is not mature yet). Joint ventures and alliances, although more complex, can be carefully designed to ensure banks maximize value from working with other organizations.

#### Strategic challenge

Technology underpins much of the change happening within the payments sector; however, many of the key questions facing banks in determining their response are strategic rather than purely technical.

Some banks see the new aggregators and PSPs as being among their best growing clients. Others see the danger of disintermediation and have been positioning themselves to respond by investing in real-time, peer-to-peer payments products that use the bank account and data analytics capabilities. At the same time, the new competitors have been constantly evolving their strategies, including businesses that started out as online only providers entering into the offline and even the point of sale (POS) lending market.

Banks in a number of western European markets have recently been divesting of their stakes in domestic automated clearing house (ACH) and cards processing infrastructure. These payments providers need to invest significantly to be able to respond to the requirements of efficient real-time settlement of retail and peer-to-peer payments; banks, in their current position are sometimes unwilling to make these investments.

#### Increased demand

The rationale for embracing technological innovation and competition and working with non-banks is that demand for quicker, cheaper, anywhere/anytime payments is growing. This is not just a commoditization process. In addition, concerns about privacy and security are growing too, which leaves room for some additional margin for service and therefore to take customer relationships further up the value chain. Business and individual customers want:

- ▶ More convenience – make a payment anywhere, any time
- ▶ Reassurance on security and privacy – payment details protected, safe transfer, particularly in relation to new payment technologies
- ▶ More transparency – fees, spreads, terms
- ▶ Greater speed – payments in real time, immediate confirmation
- ▶ No barriers to cross-border payments

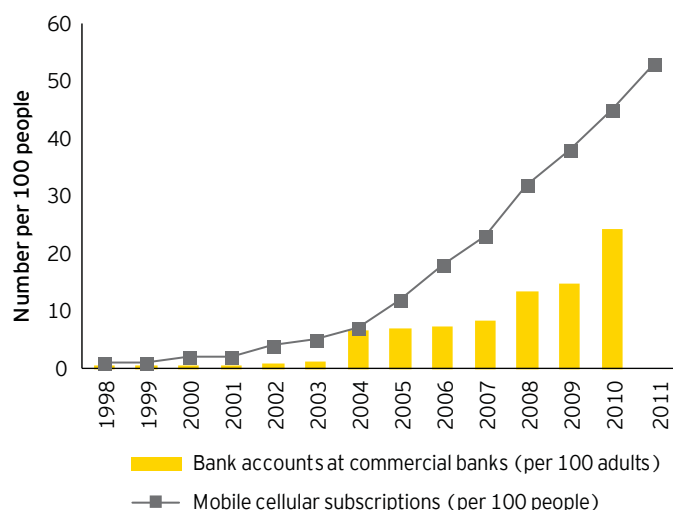
Some of these demands suggest that the best intermediaries, or partners, would be mobile phone/internet providers. A smartphone becomes a mobile wallet in a cashless society, combining the functions of credit, debit and prepaid cards. Mobile cellular phone subscriptions far exceed access to bank accounts in areas such as developing sub-Saharan Africa. Banks will face tough competition entering markets where mobile-based services become established before traditional banking services.

In this case, security and the supply of emergency funds when the device is lost or stolen will be a growing part of the service, and one suited to financial institutions that specialize in handling customer accounts. Technological innovation will enable cheap mass usage of secure forms of identification for access and authorization: fingerprints, irises or voice.

Most of these demands assume a favorable regulatory environment:

- ▶ To standardize requirements and remove national barriers (as is happening under Single Europe Payments Area in the EU)
- ▶ To protect data
- ▶ To force disclosure and to allow industry cooperation to aid standardization

**Figure 9: Analysis of cellular phone subscriptions and number of bank accounts, sub-Saharan Africa**



Source: World Bank, World Development Indicators

Further impetus to the development of new markets is likely to come via the spread of internet access and mobile devices to dispersed populations. The M-Pesa payments system, using cash credits on mobile phones, developed in Kenya, is a well-known example. Advances in mobile POS technology across a range of markets have broken down barriers to the cheap and instantaneous processing of card transactions. These technologies are frequently deployed by retailers operating without a fixed data connection and to process payments at the point of delivery.

Microfinance has attracted a lot of attention, but scalable business requires the collection of data on creditworthiness and financial performance. Bank accounts provide this; credit/debit cards also show patterns of retail spending, and other information can be gleaned from monitoring preferences on social network sites. By 2030, data analysis will enable the providers of finance to have a far more granular view of many more people and businesses, which can be used to provide value-added services. It will require both considerable investment in IT and far more data sharing.

## The role of exchanges

Another factor that will influence the flow of payments within the financial system over the next two decades is the changing role of exchanges. In particular, regulation of over-the-counter (OTC) derivatives will lead a greater proportion of transactions to be made through exchanges and centrally cleared, leading to changes in the flows of settlements, posting and management of collateral. Along with these changes come new record-keeping and reporting requirements – for example, real-time reporting of swaps data under the US Dodd-Frank Act.

A further area of innovation lies in internet-based markets – exchanges and auctions – that match buyers and sellers, lenders and borrowers, and those who wish to hedge/bet on future price movements. Peer-to-peer lending exchanges are gathering momentum in many countries and offer a tighter spread between borrowing and lending rates than is typically available through banks.

As the peer-to-peer concept develops, there will be an increasing market segmentation allowing corporate customers to lend to, or borrow from, those with a similar sector focus (i.e., they are well placed to evaluate risks for themselves). It may also support greater resource sharing between public and private sectors.

## Impact of regulation

One factor that will slow the potential disruption of new technology and new entrants is regulation. After the financial crisis, regulation is firmly focused on systemic risk reduction and control, stricter requirements for liquidity and countering tax evasion. This is in addition to the established themes of protection against money laundering and fraud, terrorist screening and anti-bribery laws. Financial institutions will have to make investments to provide the regulators with the information they need, or with reassurance that criminals cannot freely transfer and access funds. The US Foreign Account Tax Compliance Act is an example of such vigilance extending to tax evasion. Increased competition from unregulated companies will be tempered by scandals, or losses, affecting their customers.

## What does this mean for the bank of 2030?

Customers are demanding more convenience, privacy, security, speed and transparency from an emerging set of payment technologies. Significant investment will be required to meet these challenges during the next two decades. Certain of the emerging skills and technologies required within the payments industry are outside the core competency of a bank.

Other ways in which to participate in this attractive market will therefore become more important, involving a different skillset to the acquire-and-control model. These forms are not new but are underdeveloped in financial services and include joint ventures, where the other party provides market knowledge, technological know-how and distribution. The challenge is to operate the business successfully without either party having control. Another important trend will be working with permanent partners on either a product, market or business-line basis.

New business models for the sector might entail taking a minority stake or operating a federation similar to the big professional services firms. Challenges with these models arise from a lack of control, which can cause frustration and carries the risk of being associated with the partner's failures. There may be the possibility of picking temporary partners according to the project, which might lead to a more permanent relationship. The ability to operate as a junior partner, contractor or consultant could also come into play here.



### Joint ventures and alliances

"Institutions face many challenges that need to be addressed at each step of the development of a distribution alliance. However, by adopting the correct focus, institutions can help ensure that these relationships work in favor of both parties. Our experience working with clients suggests a four-phase approach can be used to maximize value.

Through undertaking a strategic approach, firms can help ensure that they obtain optimal value from their distribution alliances."

#### 1. Strategy design phase

"Firms need to form a clear view of their core and non-core activities along with the contribution of alliances within this phase. In the past, some organizations have handled alliances opportunistically rather than with regard for the overall strategy of the organization. Firms should ensure that the risks and opportunities of partnering are fully assessed and understood in shaping their strategic vision."

#### 2. Selection of alliance partners

"When selecting alliance partners, firms need to take into account a broad range of criteria, including the operating model and cultural aspects, in addition to price. The selection and pursuit process for alliance partners needs to be designed to capture these components. The relative strengths of potential partners need to be carefully evaluated in selecting the preferred partner."

#### 3. Implementation

"A joint implementation team will be needed that has experience in handling legal, commercial and operational aspects of the transition. Mechanisms should be established to promptly escalate and resolve any issues. By involving the implementation team early on in negotiations, clarity and alignment can be obtained at an early stage in the process. For example, a usual lever to get much more value from an alliance is to adopt a proper mechanism for sales support between the partners. It is often underestimated how adapted practical support can have a huge effect on sales efficiency and quality for a very limited investment; this is the 'last meter' effect."

#### 4. Optimization

"An optimal alliance will usually mean full integration of operational processes. There should be ongoing monitoring and assessment of performance measures to monitor how well the alliance is delivering its promised value. Periodically, firms should undertake reviews of both the individual alliances and the overall portfolio of alliances. At an individual level, firms should consider performance measures, proposition improvements, commercial terms and growth plans."

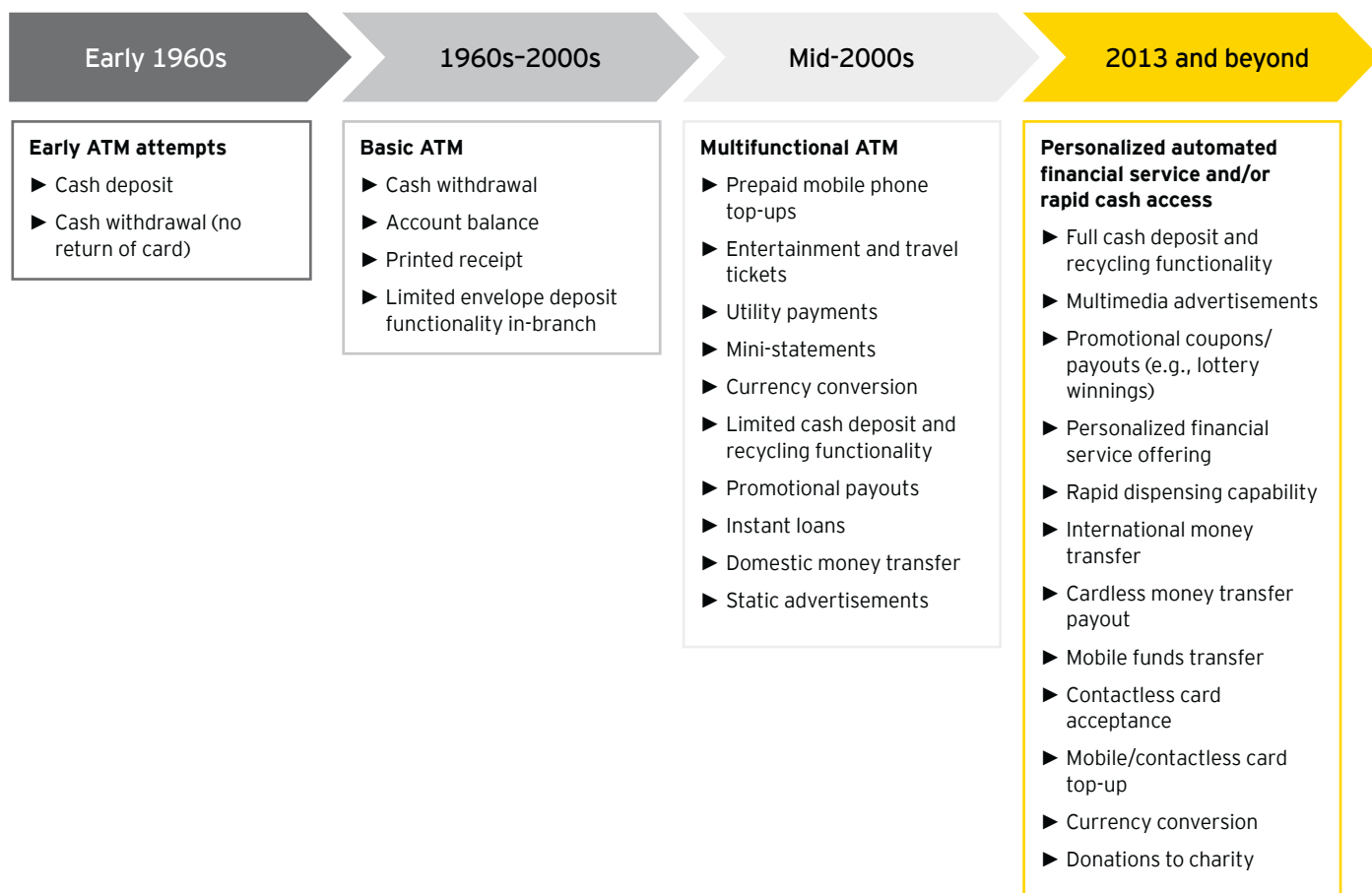
**Pierre Pilorge**, Partner, EY, France



## What does the future hold for the ATM?

Consumers are migrating away from cash as a payment mechanism to cards, driven in part by the increase in volume of online transactions. However, in many developed markets cash is still dominant and predicted to be so in the foreseeable future; the European Central Bank reports that the number of banknotes originating in the eurozone is rising by about 9% a year.

Automated teller machines (ATMs) have allowed banks to drive efficiencies and cost savings in providing cash to customers. Over time, many additional services have been added to ATMs, but there are still many more that could be added, giving the bank of 2030 many more opportunities to interact with its customers. The bank of 2030 is likely to have far more advanced machines than we can imagine today, providing more personalized and higher-value services and advice.





## 8. Energy

### Technology is challenging the old order

Since the expected growth in population is so large, and rising wealth will create more demand, the availability of resources will continue to be a dominant theme on the international growth agenda. Many of the concerns center on energy, where new developments in technology, increased demand and complex political and environmental dimensions have far-reaching consequences. As a result, major changes in the way energy is generated and delivered will occur within the next two decades, with important implications for banks that finance the activities. For these reasons we focus on energy, rather than the broader topic of natural resource availability, as our eighth theme.

One influential set of assumptions is captured in the World Energy Outlook (WEO) of the International Energy Agency (IEA). Rather like the demand for financial services, it points out that while population growth underpins energy demand, the fundamental driver is GDP. In its 2012 WEO it assumes a 26% rise in population between 2011 and 2035, and a 3.5% per annum rate of GDP growth. The latter figure would expand total GDP by nearly 2.3 times. The IEA echoes other forecasters in assuming that non-OECD countries will account for most of the growth.

Electricity demand provides a key measure of the impact of demographic changes, with urbanization also playing a role. Under the IEA's current and new policy scenarios, electricity demand is set roughly to double between 2010 and 2035, representing an increasing share of total energy demand. It grows less fast than GDP because of improved efficiency, driven by higher prices not only for the fuels but also for permission to emit carbon dioxide. In 2011, about 1.3b – one in five of the population – did not have access to electricity. This is projected to fall to about 1.0b by 2030 (unless further policy action is introduced that reduces this further).

### Technological advances

The technological advances of recent years have shown that many previously unavailable resources can be brought within reach. This is particularly well demonstrated by the shale gas revolution within the US, but also advances in the offshore oil industry.

Gases contained within shales are extremely challenging to extract, but years of research and development work in the US mean that production levels are set to rocket. This is potentially game-changing for the whole energy market, turning the US from being an importer to a possible net exporter and causing gas prices to fall dramatically. The economic and political consequences of this change are equally dramatic, particularly for current major suppliers to the market.

Shale gas extraction faces opposition in many countries from environmentalists who point to potential contamination of groundwater and also earth tremors. This will require a response from the industry that provides clarity and reassurance over the safety of techniques and processes being used.

Many other technological innovations, including within the renewables sphere, are likely to arise in coming years and disrupt established patterns and forecasts.

## Political dimensions

The links between energy supply and politics are numerous and complex. They will shape not only the energy landscape but also the balance of power between countries in coming decades. Governments will seek to balance energy security against economics and the environment, with these factors sometimes pulling in competing directions.

Energy security also raises questions of the military means necessary to protect resources and supply routes. From policing of liquid natural gas shipping lanes, to cross-border supply pipelines and offshore oil and gas sources, protection of infrastructure has cost and geopolitical consequences.

Decisions by the BRIC countries on usage of coal as part of their energy mix will heavily influence its future. Over recent years, coal has played its part in fueling growing energy demand. However, it now faces an uncertain future, to be determined, in part, by attitudes to its environmental impact, the pace of development and adoption of clean-coal technologies, and how efficiently it is used. These factors will inevitably be weighed against the large proved reserves of coal, which are far greater (at current usage levels) than those of oil and gas.

Renewables are generally domestically based, which means they support energy security goals as well as environmental ones. They also tend to be less consumptive of water, which is becoming an increasingly expensive input to production.

New alliances may take shape as a result of energy supply and demand dynamics. The promise of oil supply capacity from Iraq could be a major influence in coming years. Chinese energy companies have made investments to support the redevelopment of several of its major oil fields.

## Oil and its price volatility

Price volatility has been a feature of energy markets. Take the oil price: as recently as December 2008 it bottomed out at about US\$36 per barrel and by April 2011 it had recovered to US\$127. During 2012, it was close to that level again. The IEA's central forecast for 2035 was for crude import prices of US\$216 per barrel. Only moderate rises in natural gas prices were predicted because of the expansion of unconventional sources such as shale gas. The decoupling of gas from oil prices is a feature of the first part of this century.

The arguments about "peak" and "tight" oil supply are not limited to the level of proven reserves in the ground. Ali I. Al-Naimi, Minister of Petroleum and Mineral Resources in Saudi Arabia, wrote in the Financial Times (29 March 2012): "There is no lack of supply. There is no demand which cannot be met." His main concern was the toll high prices were taking on economic growth, particularly in the EU.

He pointed to the potential to increase supplies from Libya, Iraq and Angola (fellow OPEC members); Canada, the US and South America; and Russia, Kazakhstan and Azerbaijan. Taken with technology to convert gas to liquid and investment in pipelines, it is possible to believe his assertion that oil "will continue to power the global economy for many decades to come."

## Infrastructure and investment

The cost of projects is high. A pipeline from the North Slope of Alaska to carry gas to the southern coast, where it would be liquefied and transported by ship to Asia, is estimated at US\$40b-US\$50b. Such projects require private and public sector fund-raising, long-term supply contracts to give predictable cash flows and a stable tax regime within the home state.

Forecasting energy prices is complicated by other factors. One is the pricing of carbon dioxide emissions: under the EU's emissions trading scheme the price of permits to pollute had dwindled from US\$30/metric tonne in mid-2008 to US\$7 in early 2012. From a financial services point of view this is an interesting new market, but too many penalty-free permits were issued initially. Nevertheless, the trend is for emitters to pay and for charging schemes to go global. The IEA predicts prices of US\$30-US\$45/metric tonne by 2035, on the basis of current or envisaged government action, which may become more aggressive.

## Subsidies

While some governments are adding to energy costs by charging for emissions, others continue to subsidize energy prices. In 2011, subsidies for the consumption of fossil fuels amounted to US\$523b, according to the IEA. Reversing this would provide a massive push toward efficient use of resources. Improving energy efficiency will require investment in new plant and equipment and in modernizing transport and buildings, which will require a variety of project finance.

## What does this mean for the bank of 2030?

For big energy projects, helping governments and multinational companies to raise funds is likely to continue to be a growth market. This will create further opportunities for private infrastructure funds, and for bond issuance that links governments and their private sector partners to pools of wealth and savings. The Alaskan pipeline project may be typical of large-scale expansion of 21st-century resource output: involving governments as funders and customers, private companies as suppliers and contractors, institutional investors as significant stakeholders and creditors, through equity and bond issues. The firms advising on the projects will need a blend of financial, legal and political skills, as well as sector expertise.

The ability to predict future energy prices presents a particular challenge for major energy investments. For example, in the international gas market most trade takes place under long-term contracts, where the price is indexed to other fuels such as oil. However, changes are taking place, particularly in Europe, where increasing volumes of trade are indexed to spot prices at hubs where the gas is delivered. Some trade even takes place at spot prices for immediate delivery. These changes will require a new suite of risk management and hedging products (such as the emergence of a gas futures market) in order to underpin the investments made in production and supply infrastructure.

Individuals will want access to the income streams from these projects – and not just through the pension funds and insurers buying on their behalf. The challenge is to make bond markets as accessible as equity markets and to continue the spread of automation to match buyers and sellers and lenders and borrowers. This can take place on an increasingly small scale, facilitating investment in local projects. Innovation is also occurring in hybrid investments such as social impact bonds, where some return is forgone for the sake of social gain. Although these innovators face challenges, such as how to measure public benefit, real life examples such as renewable energy and transport schemes have demonstrated that the theory can be applied in practice. Banks can be important facilitators of this new market.







# Conclusions

Whether or not globalization continues, or goes into reverse, the financial services sector will expand over the next two decades. Growth in populations and, most importantly, in their wealth, means that businesses and individuals will carry out more transactions, invest and save more, have more assets that they want to protect and run more risks that need to be insured or hedged.

It is simplest to imagine this happening in a world where globalization continues to reduce barriers to cross-border trade and investment. But this is not necessary for the deepening of the sector. Indeed, bearing in mind the difficulty in doing business in many countries with rapid population growth, decisions about where to expand will be complicated. Local knowledge and contacts with governments, and others with influence, will be of prime importance. As the sector develops domestically first, the least risky form of entry will be via the export of advice and reciprocal arrangements arising from client activity. This can form the prelude to partnerships, joint ventures, stake-building and ultimately – but not necessarily – mergers and acquisitions.

“Globalization” may no longer be the best way to view the background to the sector’s future. This is partly because of the risks of it reversing (as the Great Moderation gives way to a multispeed world where some governments reassert national interests) and because of the strengthening of regional forces, following intra-regional trade and investment patterns.

## Changing balance of power

There will no longer be any part of the world solely dependent on the US and Europe to provide capital for investment and mass markets for products, although the residual wealth of those regions will continue to make them attractive partners. So will their financial skills, particularly in access to capital markets, cross-border M&A, investment products and services, and risk management. What the developed world can learn from the emerging world is how best to work with and for governments. Finance has always been a political issue: the West forgot this during the market liberalization that accompanied the Great Moderation.

Absent globalization as a driver of the sector’s expansion, every region and nation offers scope for financial deepening. It is perhaps easiest to think of this along customer lines because the provision of services to those customers will come from a wider range of entities. By 2030, most “banking” may be provided by non-banks.

## Deepening of services

In personal finance, even in the wealthiest parts of the world, there are sections of the population that lack deposit accounts, have limited access to credit and are underinsured. In addition, more people will realize the need to plan their own financial futures and, increasingly, they will want to direct that themselves. Employing retail shopping skills and aided by easy access to web-based information, the democratization of finance will be more important than globalization. Provision of the services that savers and borrowers seek will increasingly be by non-banks whose business models are based on using technology to analyze customer needs and to deliver a growing range of investible products via exchanges and auctions.

In corporate finance, globalization – or, more simply, cross-border transactions – will continue to be a driving force. More countries will have the large and ambitious companies that launch IPOs, execute takeovers and disposals, and raise funds on capital markets that give them access to an international investor base. These larger companies will need all the traditional advisory, underwriting and broking, and risk management services. With the investment cycle switching toward the building and renewal of infrastructure, there will also be an increasing number of public-private projects. These projects will require political and legal skills, as well as long-term project finance and the ability to work with a variety of partners.

At the smaller-business level, the story is again one of deepening. As with retail customers – and a rising proportion of them will be self-employed – access to capital will increasingly be offered by non-banks via exchanges. They will expand their sources of working capital through asset-backed finance such as invoice discounting. Securitization of pools of SME loans will become commonplace. Relatively simple risk management techniques, which limit exposure to interest rate and currency movements, will also spread, as will alternatives such as betting exchanges.



## Innovation and disintermediation

For investors, automation and disintermediation will disrupt the current multi-layer, labor-intensive process. Institutional funds will be put to work more directly in property and infrastructure projects. An aspect of this will entail monetizing public assets, such as roads, which will increase the range of income-yielding securities. Innovation will continue apace in exchange-traded products and in computer-based ways to assemble balanced portfolios. There will, of course, still be scope for fund managers and consultants to charge more for specialist advice, where the investor is prepared to take more risk in pursuit of higher returns.

## The role of governments

Finally, governments will be both one of the most important clients for financial services over the next two decades and, together with regulators, the biggest single influence. In the developed world, heavy state debts will drive bond issuance, while in the emerging world (even in relatively mature countries such as Russia) government bond markets have massive scope for development. There will be large privatization programs – of businesses that have been nationalized, notably banks in the West and, elsewhere, the IPOs of a variety of state-owned assets. Governments will be partners in infrastructure projects and in the provision of public services by the private sector. And, combined with the activities of central banks – even ostensibly independent ones – they will have a profound influence on the cost of capital, the sector's raw material.

## Responding to the changing landscape

During the global financial crisis, bank strategy teams and CDOs were asked to respond to signs of organizational stress both from within their own organization and as seen from competitors. This has included exiting non-core businesses, undertaking disposals mandated by the European Union (for organizations that required state aid) and quickly providing a commercial perspective on events as they unfolded. Conversely, banks were also required to quickly evaluate acquisition opportunities that would not have become available in a normal market. These situations showed the huge value available from banks' internal skillsets and highlighted a trend for growing diversity and flexibility in what will be asked of strategy and CDOs in the future.

Resolution and recovery plans are another area where banks' strategy and CDO skillsets have proved valuable. Under these plans, banks may be required to execute recovery actions, such as selling businesses, which bolster the group's capital position. This further expands the traditional remit of CDOs in particular, in considering scenarios where they must "think the unthinkable" and then work out "what next?"

Regulatory forces are an increasingly important force in shaping the financial services landscape. Executing transactions in 2030 will inevitably demand a strong understanding of regulatory concerns and how these areas can be managed and mitigated.

## In conclusion

The Great Moderation, with the centripetal forces that led to financial complacency, will give way to the great uncertainty, with a greater incidence of political, economic and financial shocks. While this will threaten some legacy business models, it will not halt the development of the sector. Centrifugal forces will present new opportunities to expand, and increased diversity will make the sector more resilient. M&A will play an important role in this expansion and in navigating the themes dominating the industry over the next 17 years, but agility in its broadest sense will be critical.

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