09 WORLD RETAIL BANKING REPORT

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EFMA

Contents

Preface

Capgemini and the European financial management & marketing association (Efma), and their new partner, UniCredit, are pleased to present this sixth annual edition of the *World Retail Banking Report*. As in the five previous editions, it provides overviews and insights into the global retail banking industry's dynamics, with a pricing section focusing on the world's retail banking pricing structure, and a spotlight section analysing a current crucial retail banking issue. This year we take a close look at the global mortgage industry.

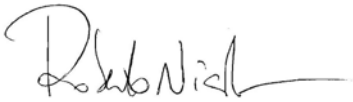
The geographic scope of this year's edition covers 26 countries, including one new country, Russia. The number of retail banks it covers rose from 194 to 203.

We continue our investigations into the worldwide pricing of day-to-day banking products and services, presenting our findings in a yearly pricing index. (Our website, *www.wrbr09.com,* also provides a dashboard of each country's national banking industry.) To integrate retail banking's market evolution and the increasing role the Internet plays in operations, we have introduced four new Internet products and services and developed two new usage profiles, *branch user* and *Internet user*. These profiles helped us analyse the impact the Internet is now having on customers' consumption patterns and retail banks' pricing strategies.

Our spotlight section this year focuses on mortgage profitability. We have analysed the impact the current financial and real estate crises are having on retail banks' business models, and how—confronted with this change to their usual environment—retail banks can address this new market situation. Our analysis is based on three different investigations: a market survey, qualitative bank interviews, and an in-depth profitability analysis. The results highlight several major future challenges retail banks will face in the mortgage sector, and outline some key solutions banks will need to succeed.

It is with great pleasure that we publish this 2009 edition of the *World Retail Banking Report*. We hope its findings will answer some questions and stimulate debate among retail bankers. Most of all, we want to provide useful information that helps retail bankers deal more effectively with the difficult operational and strategic issues they will face in the years ahead.

Bertrand Lavayssière
Managing Director
Global Financial Services
Capgemini



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PRICING INDEX

Principal Findings

- The average price of basic banking services for the local active user fell 2% from last year, to €70.3, with average prices ranging from €54.3 in Asia-Pacific to €76.6 in Europe Non-Eurozone.
- Except for Europe Non-Eurozone (up 1.6%), all regional area prices decreased, down 6.1% in Europe Eurozone and 1.4% in North America.
- The downward trend in prices since 2005 continues: the compound annual growth rate (CAGR) for all regions, 2005 to 2009, was (-1.2%).
- The primary cause of this decrease was the decline in Europe Eurozone, mostly due to the introduction of packages in Ireland (down 33%).
- The secondary cause was the development of differentiated pricing per distribution channel: Internet active users paid €9.5 less per year than active users, and €31 less than branch active users.
- The fee structure parallels our 2006 findings, with payments accounting for about 50% of retail bank revenues, and account management for 25%.
- The SEPA (Single Euro Payments Area) effect on prices continues its downward trend: the price of electronic payments fell by nearly €4 in Europe Eurozone (to €57, down from €60.9).
- Prices continue to converge in Europe Eurozone and North America, while we recorded large discrepancies in Asia-Pacific and Europe Non-Eurozone.
- Overall, Europe Eurozone prices decreased by 6.1%, a phenomenon largely explained by drastic declines in Ireland (down 33%) and, to a lesser extent, Spain (down 7.2%); but, excluding Ireland, Europe Eurozone prices actually rose by 0.8%.
- In Europe Non-Eurozone, prices increased by 1.6%, despite price declines in the Nordic countries and Poland, resulting from pricing incentives to push clients towards Internet banking.
- North America's varying fee structures can be explained by Canada's reliance on cash revenues, while the US relies on payments fees.
- Asia-Pacific remains extremely heterogeneous, containing countries with very different fee structures and pricing levels; the region's overall price decrease (down 2.3%) was caused by a decline in payments revenues and a drastic price cut in India (down 34.7%).
- Prices should continue to decline as Internet use increases, especially in less mature markets such as Central European countries.

METHODOLOGY

For this 2009 edition of the *World Retail Banking Report*, we have included 26 countries in the geographic scope of the price index, with Russia added (see Figure 1.1). The number of participating banks rose from 194 in 2008 to 203 this year.

We chose banks in an effort to meet a market-share target of 80% for each country, and we either hit or were close to that target in most cases. Once again, our analysis compared retail banking in four regions: Europe Eurozone, Europe Non-Eurozone, North America, and Asia-Pacific. The price index measured prices consumers paid for day-to-day banking services.

FIGURE 1.1
Banks Surveyed

Region	New Countries in 2009 WRBR	Countries in 2008 WRBR	Number of Banks	Market Share of Deposits
Europe Eurozone		Austria	6	76%
		Belgium	4	66%
		France	10	88%
		Germany	7	68%
		Ireland	5	100%
		Italy	6	65%
		Netherlands	6	91%
		Portugal	6	84%
		Spain	16	86%
Europe Non-Eurozone		Croatia	7	83%
		Czech Republic	5	81%
		Norway	6	66%
		Poland	11	83%
		Romania	11	86%
	Russia[a]		13	61%
		Slovakia[b]	6	87%
		Sweden	6	84%
		Switzerland	6	100%
		UK	6	88%
North America		Canada	6	93%
		US	8	35%
Asia-Pacific		Australia	5	65%
		China	9	69%
		India	9	47%
		Japan	20	77%
		Singapore	3	86%
TOTAL countries/banks		**26**	**203**	

Source: Capgemini analysis, 2009.

[a] Throughout this report, Russia was included in the scope of the Europe Non-Eurozone region.

[b] Although Slovakia entered the Eurozone on 1 January 2009, for the purposes of this investigation—carried out at the end of 2008—it was treated in Slovakian crowns (SKK).

Most of the data for this 2009 edition was collected during the last three months of 2008. We continued to focus on four categories of banking products and services: account management, cash utilisation, exceptions handling, and payments. Figure 1.2 shows the components of each category. To distinguish branch from Internet usage, we split the four product and service categories (internal wire transfers, external wire transfers, standing orders, and direct debits) into branch and Internet products (see also Figure 1.5).

To compare prices from the consumer's point of view, we defined a range of products and services that reflected the typical consumer's banking behaviour for each country studied. We called these "local profiles", and divided them into three main frequency-of-use categories: less active, active, and very active users (also shown in Figure 1.2).

We divided the total customer community into these three categories. The 20% with the lowest consumption of banking services were considered the *less active* users, the 20% consuming the most were the *very active* users, and the remaining 60% were the *active* users. The price index built on these local profiles measured what consumers in a particular country, at these frequency-of-use levels, paid annually for their day-to-day banking services.

This year, for the first time, we analysed the local active user's frequencies of use, developing two new profiles beyond that of the active user: the *branch* active user, who uses branches exclusively, and the *Internet* active user, who uses the Internet as often as possible.

FIGURE 1.2 **Products and Services in the Global and Local Pricing Indexes**

Core Day-to-Day Banking Needs	Twenty-three Products and Services (*Four new products)
Account Management	Current account Online banking Call centre
Payments	Cheque Debit card Credit card Branch internal wire transfer ****Internet internal wire transfer*** Branch external wire transfer ****Internet external wire transfer*** Branch standing order ****Internet standing order*** Direct debit ****Internet direct debit***
Cash Utilisation	Cash deposit at desk Cash deposit at ATM Withdrawal at desk Withdrawal at bank's ATM Withdrawal at other banks' ATMs
Exceptions Handling	Debit card stop payment Cheque stop payment Document search Banker's draft

Five Usage Patterns (*Two new usage patterns)	
Less Active Users	Represent the 20% of users with the smallest frequencies of use
Active Users	Account for 60% of the population
Very Active Users	Represent the 20% of users with the highest frequencies of use
***Branch Active Users**	Users using only branch products. Based on the active user patterns
***Internet Active Users**	Users using only Internet products when available. Based on the active user patterns

Two Profiles	
Local Profile	Estimated for each country to better reflect local consumption habits Variations based on this profile can be observed This allows comparison of price levels based on local consumptions
Global Profile	Same frequencies of use are applied to all countries This allows comparison of price levels based on a single profile

Source: Capgemini analysis, 2009.

As in previous editions, we also developed a global profile to compare prices around the world. It is not governed by local product usage, which varies by country, but by a standard range of products common to all countries. While not as precise as the local profile, this method is a practical means of effectively comparing global banking prices.

When comparing prices over the course of more than one year, we consistently used prices based on profiles as updated for this 2009 edition of the *World Retail Banking Report*.

All comparisons between our 2006, 2007, 2008, and 2009 editions were made on the basis of three factors:

- *A flat exchange rate:* To compare price evolutions from 2008 to 2009, without those figures being skewed by exchange rate effects, we recalculated last year's prices for those countries that use a currency other than euros based on exchange rates of 8 September 2008.
- *A same-country scope:* For the few countries added over the years since 2006 (Croatia, India, Ireland, Japan, Romania, Russia, and Singapore), we assumed a flat price evolution between 2006 and their first year in the report.
- *One frequency pattern:* The price focus of the comparisons was ensured by recalculating the price indexes of the previous years based on this year's frequencies of use (eliminating effects from change of patterns).

As a result, the recalculated price indexes differ from those published in previous years' reports. For instance, the 2008 local profile price index is €71.8, compared to €70 published in our 2008 edition.

NEW COUNTRY IN OUR 2009 REPORT

Russia

In a country where more than 1,100 retail banks operate, the Russian market is very fragmented, with 50 major banks accounting for 83% of total deposits, and 200 banks accounting for 79% of total loans. Despite the large number of competitors, the market is dominated by Sberbank, which covers about 47% of deposits and 32% of loans.

Many of the common financial products and services used around the world are not widely available in Russia. These include online banking, which, given the large percentage of elderly citizens (20.6%) and the high cost of living, is accessible only to approximately 10% of the population.

Customers often consider Russian banks merely as deposit banks, and many do not use credit or debit cards. Branches remain the most important distribution channel. Special branches exist to deal with mortgages.

Pricing between Russian banks differs significantly (with a discrepancy of about 70%), as the geographic development and the types of customers vary greatly from one bank to another. Competition in large cities is fierce, while the market in the outlying regions is not yet saturated.

When divided into four primary product/service categories—account management (24%), cash utilisation (32%), payments (43%) and exceptions handling (1%)—Russia's fee structure is close to that of Eastern Europe.

GENERAL PRICING ANALYSES

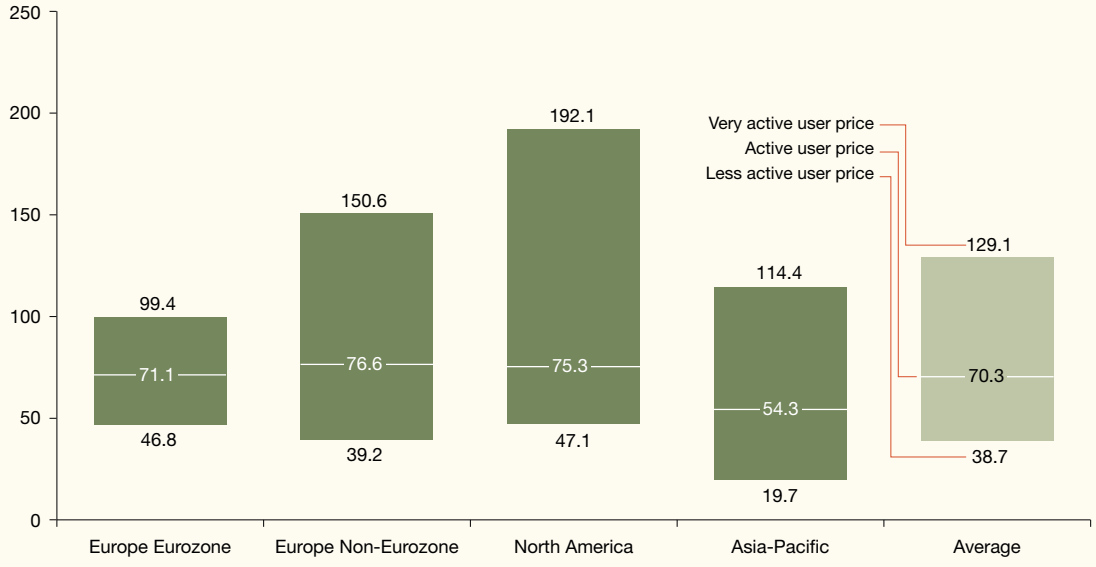
Local Profile

Worldwide, local active users paid an average of €70.3 a year for their day-to-day banking needs. As Figure 1.3 illustrates, average price levels varied from one region to another, ranging from a low of €54.3 in Asia-Pacific to €76.6 in Europe Non-Eurozone.

The average price paid by less active users of bank products and services was €38.7, compared to the very active users' much higher price of €129.1, or about three times more. These prices are, of course, averages, and the situation varies greatly by region, as Figure 1.3 illustrates. In Europe Eurozone, for instance, most banks charge the three user groups similar prices—very active users pay only twice as much as less active users. In contrast, Asia-Pacific banks charge very active users more than five times the price that less active users pay.

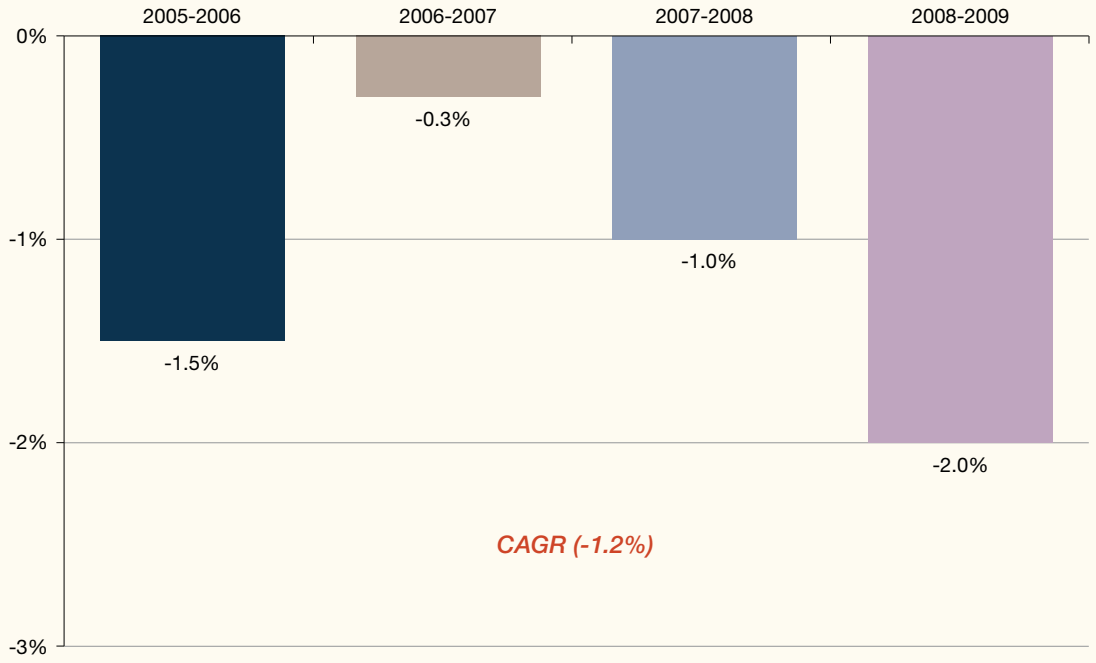
Figure 1.4 shows the evolution of prices for an average local active user from 2005 to 2009. On a global scale, prices have been effectively declining for the group over this period, with a compound annual growth rate of (-1.2%) for the four years investigated.

FIGURE 1.3 **Average Local Profile Prices by User Frequency, 2009 (€)**



Source: Capgemini analysis, 2009.

FIGURE 1.4 **Evolution of Local Active Profile Prices, 2005 to 2009 (%)**



Source: Capgemini analysis, 2009, and previous *World Retail Banking Report* editions.

NEW THIS YEAR: INTERNET ACTIVE USERS VS. BRANCH ACTIVE USERS

For this year's edition, we wanted to go even further in analysing local customer usage, by looking more precisely at the influence of the Internet in terms of pricing. We added two new usage patterns based on the local active user's frequencies: the *branch* active user, who uses only branches, and the *Internet* active user, who uses the Internet whenever possible (Figure 1.5).

FIGURE 1.5 **Comparison of Products and Services for Branch Active, Active, and Internet Active Users**

Needs	Products and Services	Branch Active User	Active User	Internet Active User
Account Management	Current account	X	X	X
	Online banking		X	X
	Call centre	X	X	X
Payments	Cheque	X	X	X
	Debit card	X	X	X
	Credit card	X	X	X
	Branch internal wire transfer	X	X	
	Internet internal wire transfer		X	X
	Branch external wire transfer	X	X	
	Internet external wire transfer		X	X
	Branch standing order	X	X	
	Internet standing order		X	X
	Direct debit	X	X	
	Internet direct debit		X	X
Cash Utilisation	Cash deposit at desk	X	X	X
	Cash deposit at ATM	X	X	X
	Withdrawal at desk	X	X	X
	Withdrawal at bank's ATM	X	X	X
	Withdrawal at other banks' ATMs	X	X	X
Exceptions Handling	Debit card stop payment	X	X	X
	Cheque stop payment	X	X	X
	Document search	X	X	X
	Banker's draft	X	X	X

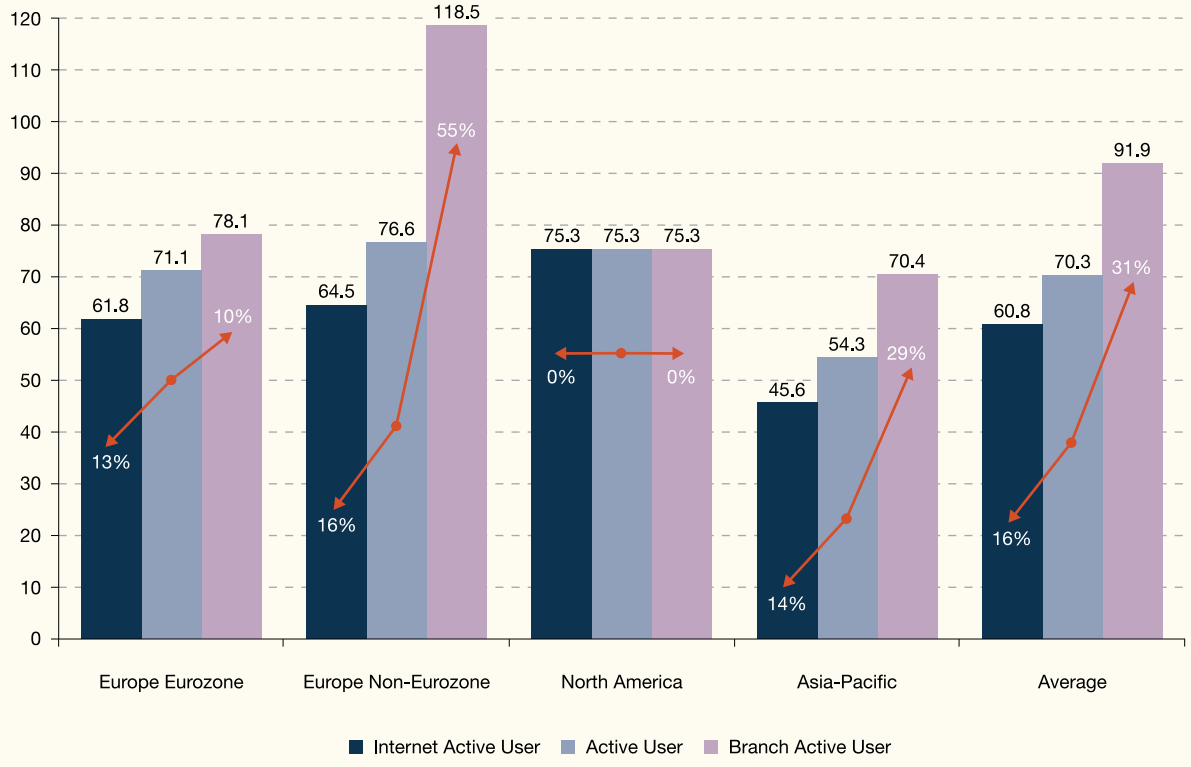
Source: Capgemini analysis, 2009.

On average, an Internet active user paid €9.5 less than an active user (16% less), and about €31 less than a branch user (34% less) (see Figure 1.6).

Most of the countries in this year's study had pricing policies in which Internet services were less expensive than branch services. For example, certain Nordic countries established extremely attractive prices for online services to move clients towards the Internet whenever products were available. Frequencies of use indicate that this pricing strategy directly influences customer behaviour.

Contrary to the global trend, a few countries priced their Internet usage higher than their branch services. An example of this is Russia, where banks have kept online banking fees elevated.

FIGURE 1.6 **Comparison of Prices for 2009 Branch Active, Active, and Internet Active Users (€)**



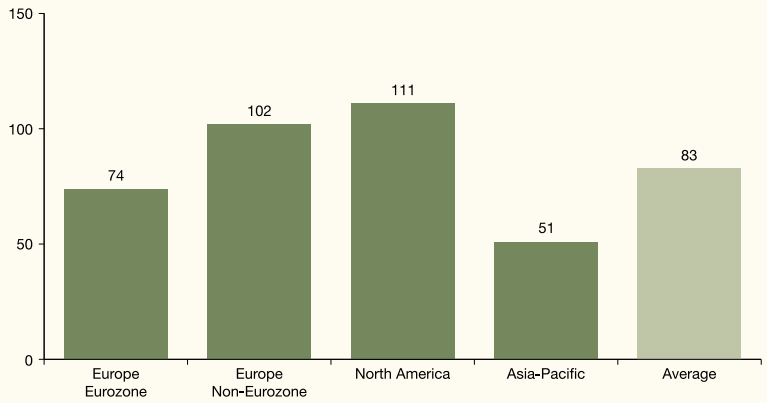
Source: Capgemini analysis, 2009.

GLOBAL PROFILE

While frequency of use is an important measure of average local prices, our pricing benchmark made it necessary to develop a standard client profile that could be used across retail banks, regardless of their clients' behaviours. For the purposes of this study, we therefore computed an average user profile, based on a single global active user profile with a sole frequency of use. This is explained in more detail in the Methodology section above.

According to our global profile price index, North America (€28 above the world average) and Europe Non-Eurozone (€19 above) remain the two most expensive regions (Figure 1.7). However, as shown in Figure 1.8, their evolution over the course of the year varied greatly. Prices in North America dropped by 1.6%, and prices in both Europe Eurozone (down 5.6%) and Asia-Pacific (down 6.9%) also decreased. Europe Non-Eurozone registered the only price increase of the year (up 6.1%). Globally, the average price remained nearly steady (down only 0.2%).

FIGURE 1.7 **Global Profile Prices, Active Users, 2009 (€)**



Source: Capgemini analysis, 2009.

FIGURE 1.8 **Evolution of Global Profile Prices, Last Year vs. This Year (%)**

Source: Capgemini analysis, 2009.

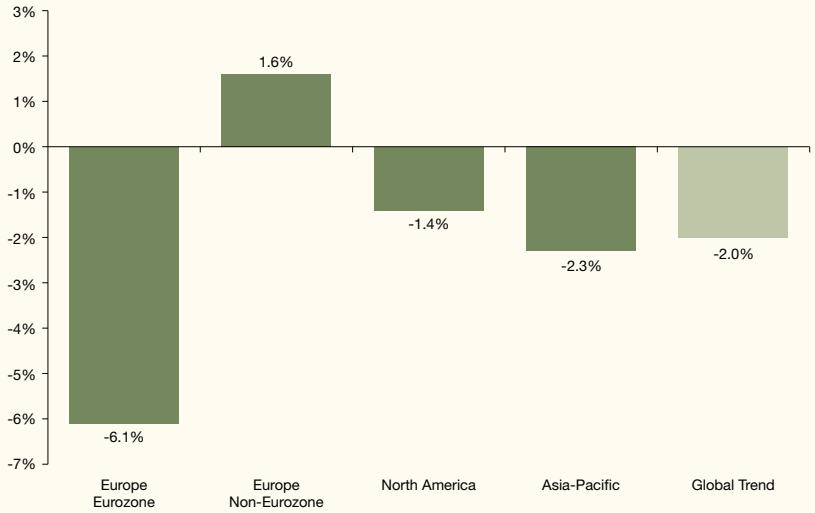
REGIONAL PRICING ANALYSES

In contrast to other banking activities, such as asset management or investment banking, retail banking is essentially a local business. National retail banking markets are for the most part unaffected by other national markets, although economic integration at the regional level (European Community, NAFTA) has begun to have an impact. Based on our investigations in past editions, we know that a regional pricing analysis is the key to generating the most accurate results.

As illustrated in Figure 1.9, overall prices are decreasing slightly for all regions except Europe Non-Eurozone—down by 1.4% in North America, 2.3% in Asia-Pacific, and 6.1% in Europe Eurozone.

Each region and country is shaped by its history. In the regional analyses that follow, we paid particular attention to the data collected for previous editions of this report to put this year's changes into perspective.

FIGURE 1.9 **Evolution of Local Profile Prices, Last Year vs. This Year (%)**



Source: Capgemini analysis, 2009.

Figure 1.10 illustrates the average percentage price evolution of core banking services by region from 2005 to 2009.

Europe Eurozone had the greatest total decrease across the four years, with a negative CAGR (-2.31%). Europe Non-Eurozone was the sole region to have a positive CAGR (0.75%) during that period. North America had a marked volatility, with years of important decreases followed by stability in 2006 to 2007, and a subsequent rise in 2007 to 2008. Meanwhile, Asia-Pacific's prices decreased in the past two years, after two years of price increases.

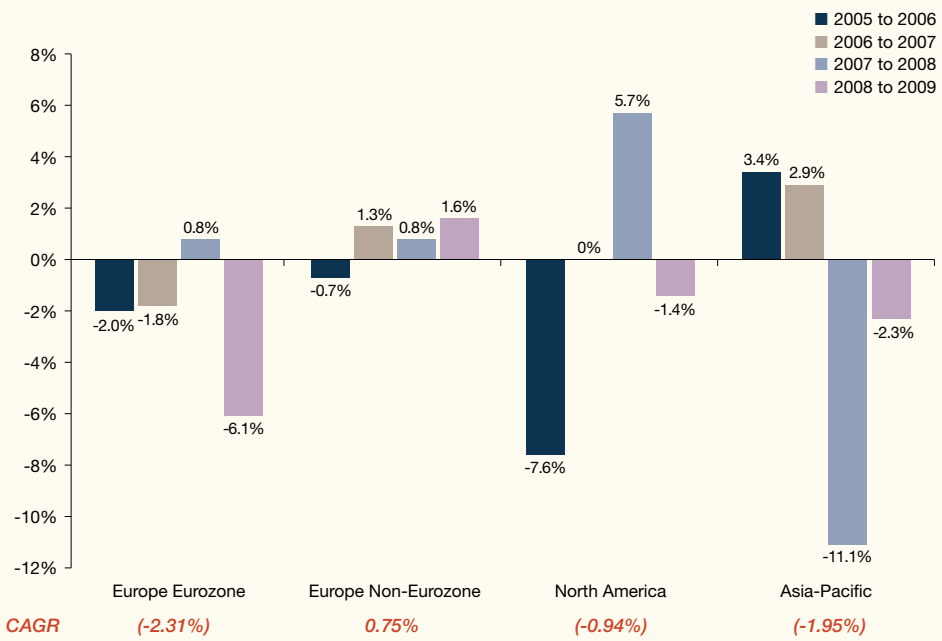
REGIONAL COMPARISONS

As Figure 1.11 shows, global fee structures have remained relatively steady over the past four years, but regional fee structures have varied greatly. Account management fees, which make up over a third of fees in Europe Eurozone, are absent in the North American configuration. Across all regions, payments continued to represent the largest part of the fee structure, but the spectrum varied from a high of 66% in North America to a low of 47% in Asia-Pacific.

The fee structures also illustrate the Internet effect. From 2006 to 2008, account management fees had been driven down as a result of the Internet (free online banking subscriptions). But over the course of the past year, this trend has reversed, and customers have moved their payments online where fees are lower, thereby lessening the part of payments in the fee structure.

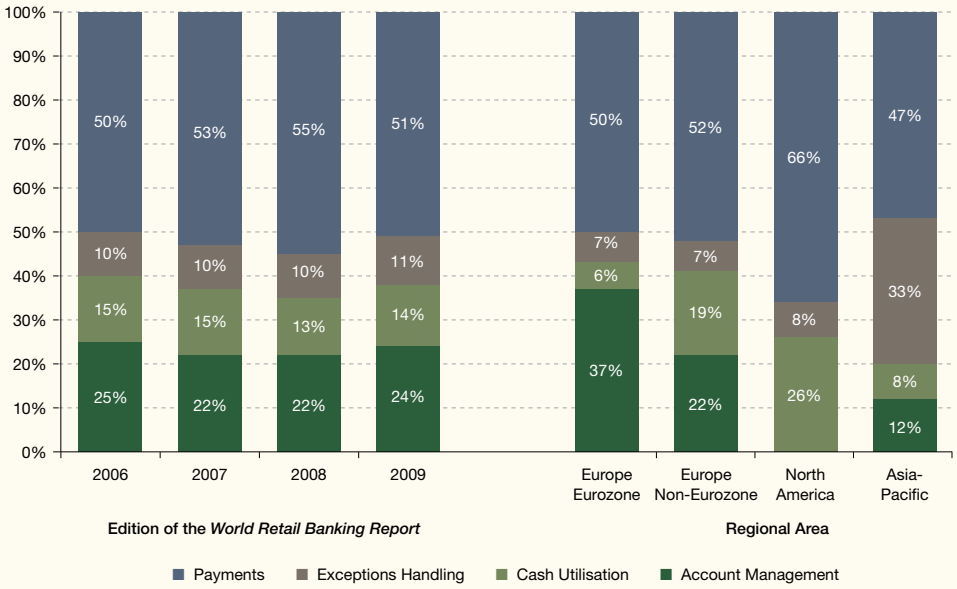
Strong discrepancies can be noted between regions as well as within each region. Figure 1.12 illustrates the standard deviation between countries' prices within each regional area, from 2006 to 2009. Prices have continued to converge in Europe Eurozone and in North America, while large divergences have occurred in Asia-Pacific and Europe Non-Eurozone.

FIGURE 1.10 **Evolution of Local Active Profile Prices by Region, 2005 to 2009**



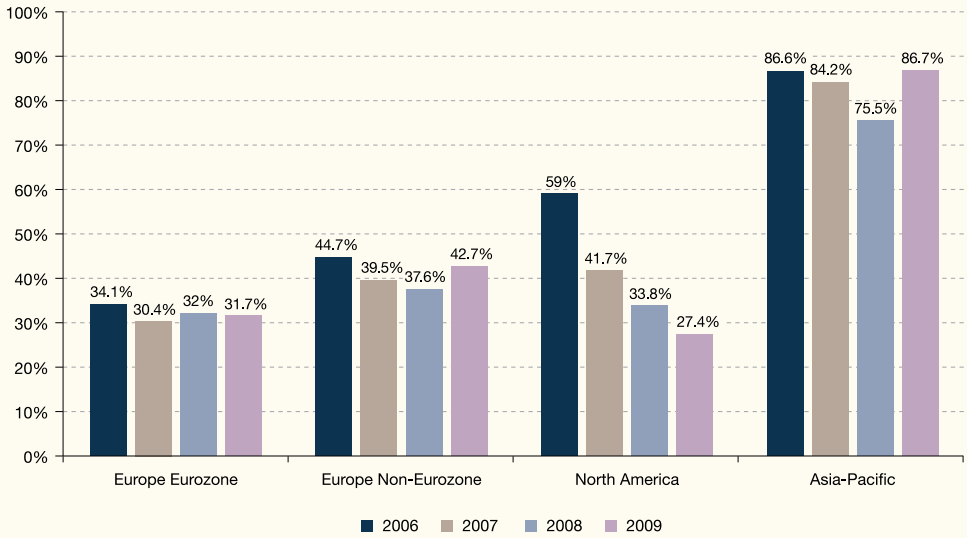
Source: Capgemini analysis, 2009, and previous *World Retail Banking Report* editions.

FIGURE 1.11 **Global Fee Structure by Year and Region (%)**



Source: Capgemini analysis, 2009, and previous *World Retail Banking Report* editions.

FIGURE 1.12 **Regional Price Discrepancies for Local Active Users, 2006 to 2009 (%)**



Source: Capgemini analysis, 2009, and previous *World Retail Banking Report* editions.

EUROPE EUROZONE

The Europe Eurozone fee structure is far from homogeneous. While payments are historically the most important part of the fee structure, Germany, the Netherlands, and Italy all had a higher percentage of account management fees (see Figure 1.13).

Europe Eurozone is the region where prices have decreased the most (down 6.1%). This decrease is due mainly to payments (down €7) and cash utilisation (down €1.3), despite the increase in account management fees (up €3.3, mainly due to current accounts) (see Figure 1.14). Banks reduced Internet payment fees to encourage customers to use the Internet instead of branches.

This year, big price decreases occurred in Ireland (down 33.3%) and Spain (down 7.2%). In Ireland, the introduction of packages, including many automated transactions free of charge, is responsible for the decline. Beginning in 2006, many of Spain's major banks (led by Santander) began an effort to curb attrition and capture new clients by eliminating commissions associated with banking transactions for preferred clients.

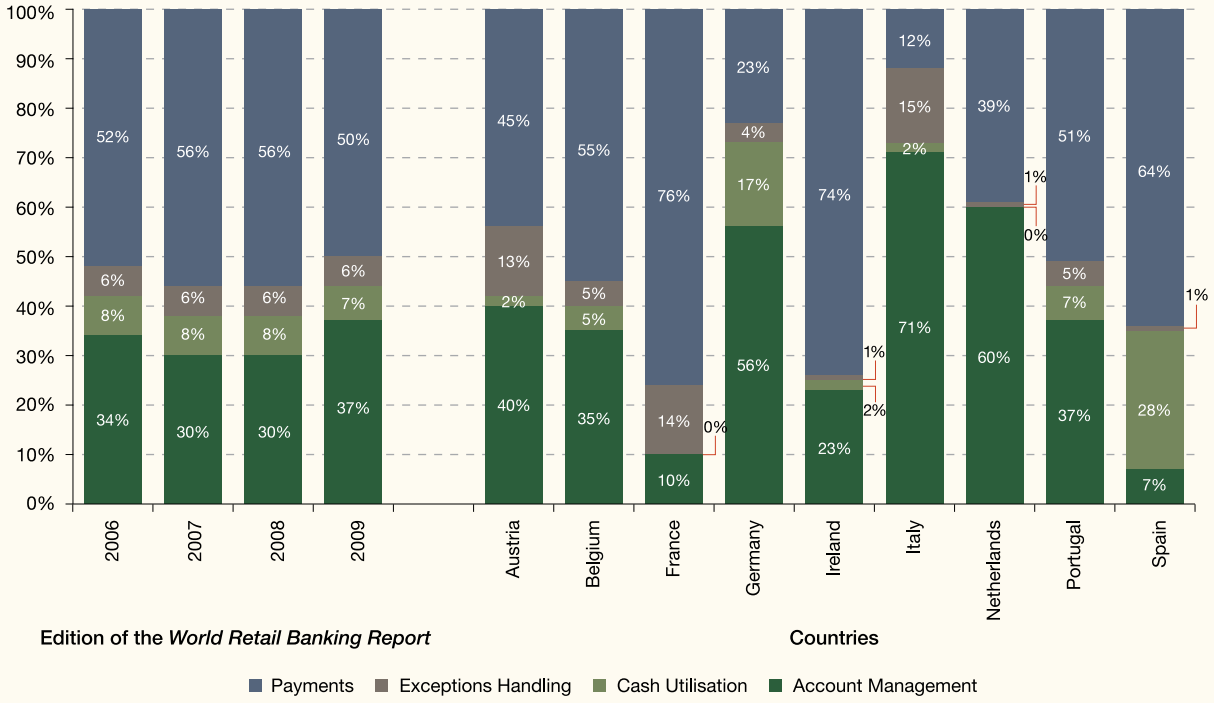
Excluding Ireland, Europe Eurozone prices actually rose by 0.8%.

The Single Euro Payments Area (SEPA) will lead to lower prices. We continued last year's efforts to track SEPA's impact on day-to-day banking prices. The expected result was that SEPA's standardised payments structure across the Eurozone would lead to tougher competition and lower prices.

To check this expectation, we computed the prices of pan-European payment means, which we defined as the range of products that will progressively be governed by SEPA's pan-European standards and regulations. These include internal and external wire transfers, direct debits, credit and debit cards, and their underlying current accounts. This year, these products accounted for 64% of the fees paid by local active users in Europe Eurozone.

The price of this range of products decreased in Europe Eurozone from €60.9 to €57 (see Figure 1.15). In Europe Eurozone, the 2006 to 2009 CAGR for these products was (-3.6%). By comparison, outside of the Eurozone the prices of these products remained relatively stable (only a €0.7 decrease). We concluded, therefore, that SEPA continues to drive down prices in Europe Eurozone.

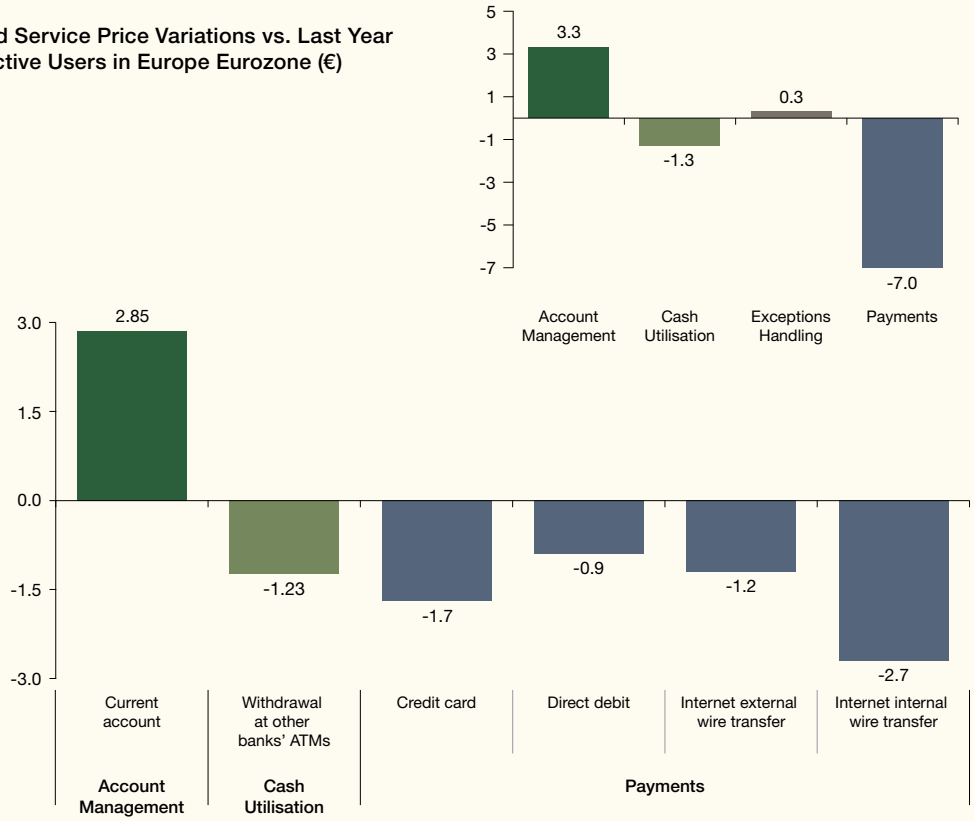
FIGURE 1.13 **Sources of Fees for Core Banking Services in Europe Eurozone (%)**



Source: Capgemini analysis, 2009, and previous *World Retail Banking Report* editions.

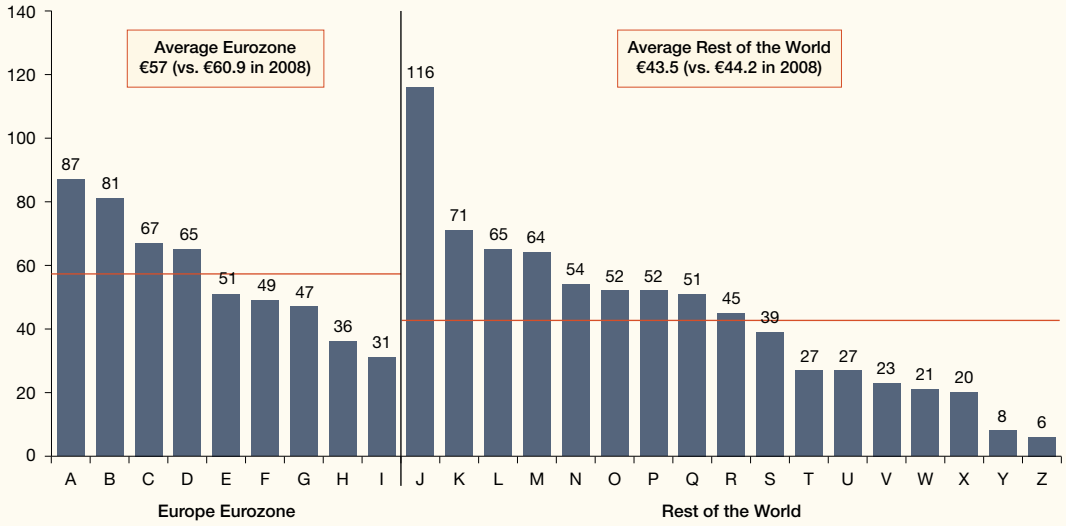
FIGURE 1.14

Product and Service Price Variations vs. Last Year for Local Active Users in Europe Eurozone (€)



Source: Capgemini analysis, 2009.

FIGURE 1.15 **Price of Payment Means for the Local Active Profile, 2009 (€)**



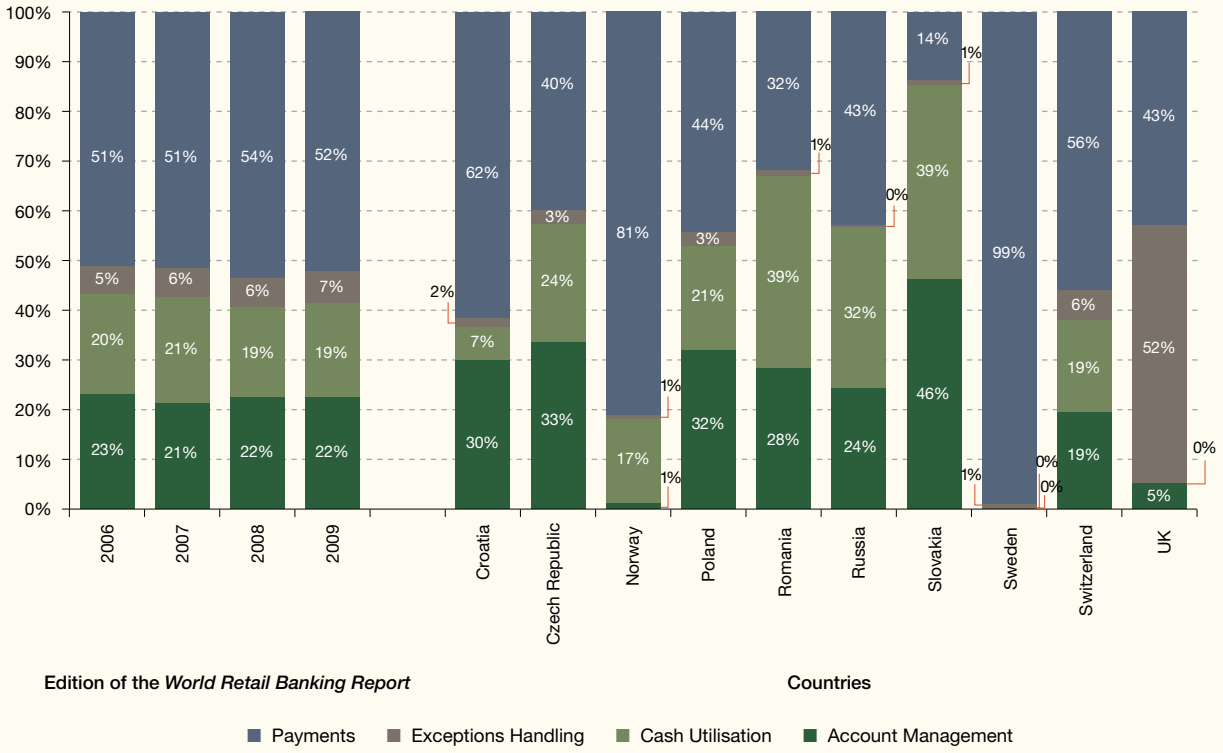
Source: Capgemini analysis, 2009.
Note: Letters represent countries and their price of payments means.

EUROPE NON-EUROZONE

The fee structure in Europe Non-Eurozone falls between the North American and Europe Eurozone patterns (see Figure 1.16). This can be explained by the combination of Nordic countries on one hand, which feature US-style fees heavily dependent on payments, and of Eastern European countries on the other, where banks charge relatively high prices for account management and cash utilisation. The UK does not fit in either of these categories, but instead features an original pattern that relies on exceptions handling.

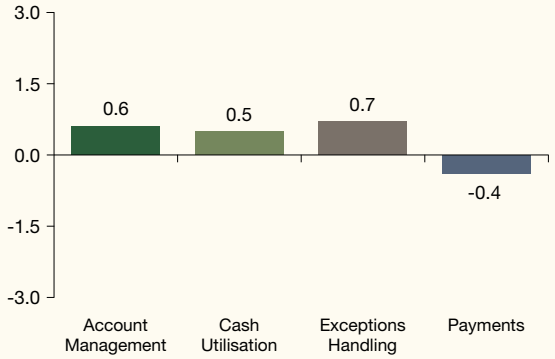
In Europe Non-Eurozone, prices increased by 1.6% for local active users. In payments, banks decreased credit card fees. They also increased fees for branch wire transfers and decreased them for Internet transfers to encourage customers to use the Internet. This strategy almost made up for the cut in credit card fees. The banks also dropped fees for withdrawals at their own ATMs, while increasing those for other banks' ATMs, to encourage customers to withdraw money at their own distributors. They raised fees for current account management (see Figure 1.17).

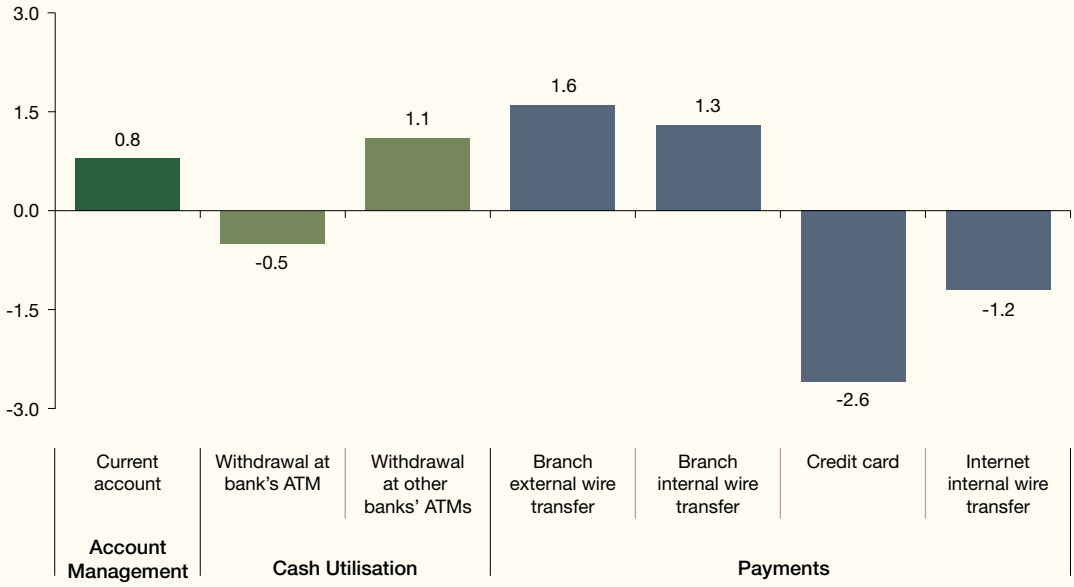
FIGURE 1.16 **Fee Sources for Core Banking Services in Europe Non-Eurozone (%)**



Source: Capgemini analysis, 2009.

FIGURE 1.17 **Product and Service Price Variations vs. Last Year for Local Active Users in Europe Non-Eurozone (€)**





Source: Capgemini analysis, 2009.

NORTH AMERICA

The structure of North American pricing has evolved slowly over the years. Most banks in this region have offered free account management since 2005, balanced by two other fee categories: payments (as much as 79% in the US) and cash utilisation (50% in Canada, the highest of any country) (see Figure 1.18).

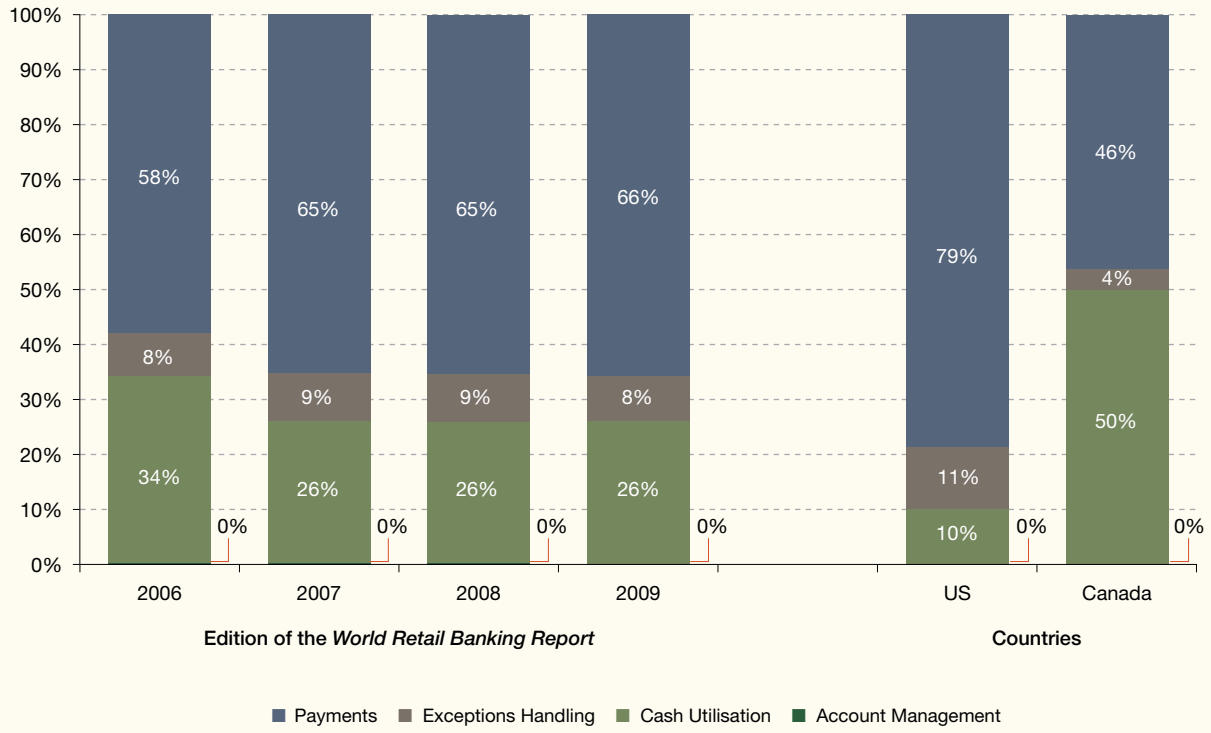
North America registered a moderate price decrease. North American prices decreased by 1.4% for local active users over last year (see Figure 1.19). The principal cause of this decrease can be attributed to Canada, where prices dropped by 3%, while in the US, prices remained steady.

Prices for all product and service categories decreased, but especially in payments (down €1), where (unlike last year) banks reduced the price on branch wire transfers to become more competitive.

ASIA-PACIFIC

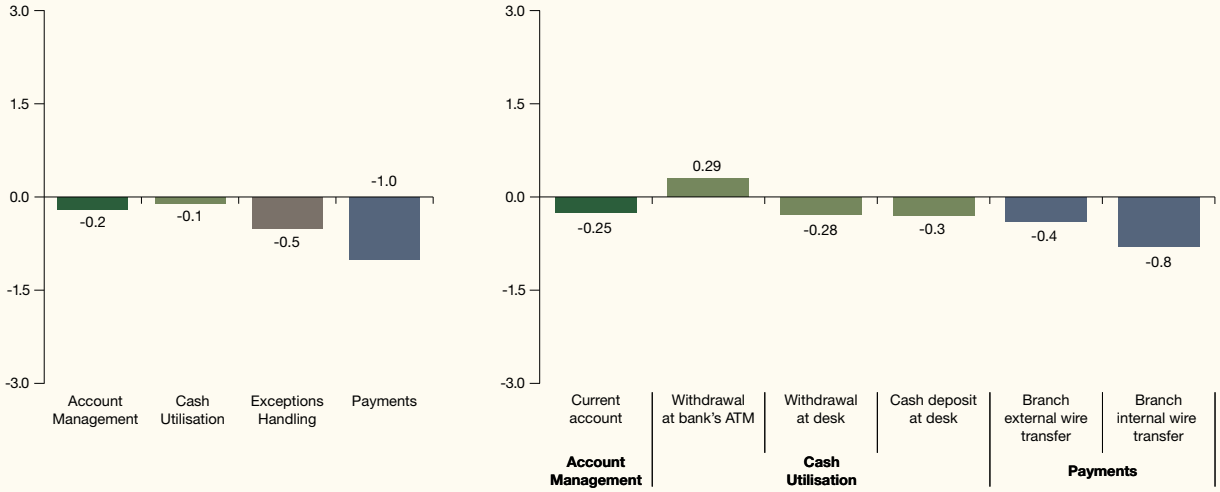
Asia-Pacific's pricing structure has become more consistent across our four product and service categories (see Figure 1.20). Its overall structure results from the combination of two types of countries: those such as China, Japan, and Singapore, which followed the US pattern of free account management and heavy payments fees, as opposed to those following the UK pattern, such as Australia and India, whose fees from exceptions handling greatly overshadowed those from payments.

FIGURE 1.18 **Sources of Fees for Core Banking Services in North America (%)**



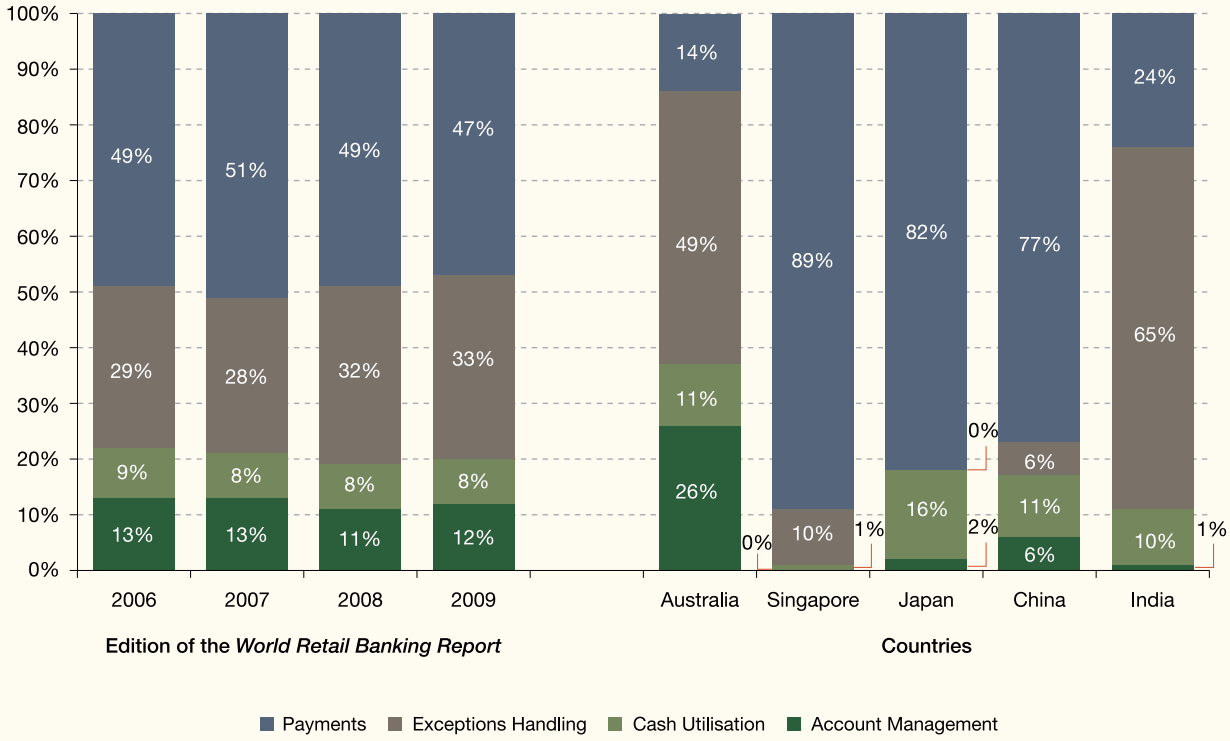
Source: Capgemini analysis, 2009, and previous *World Retail Banking Report* editions.

FIGURE 1.19 **Product and Service Price Variations vs. Last Year for Local Active Users in North America (€)**



Source: Capgemini analysis, 2009.

FIGURE 1.20 **Sources of Fees for Core Banking Services in Asia-Pacific (%)**

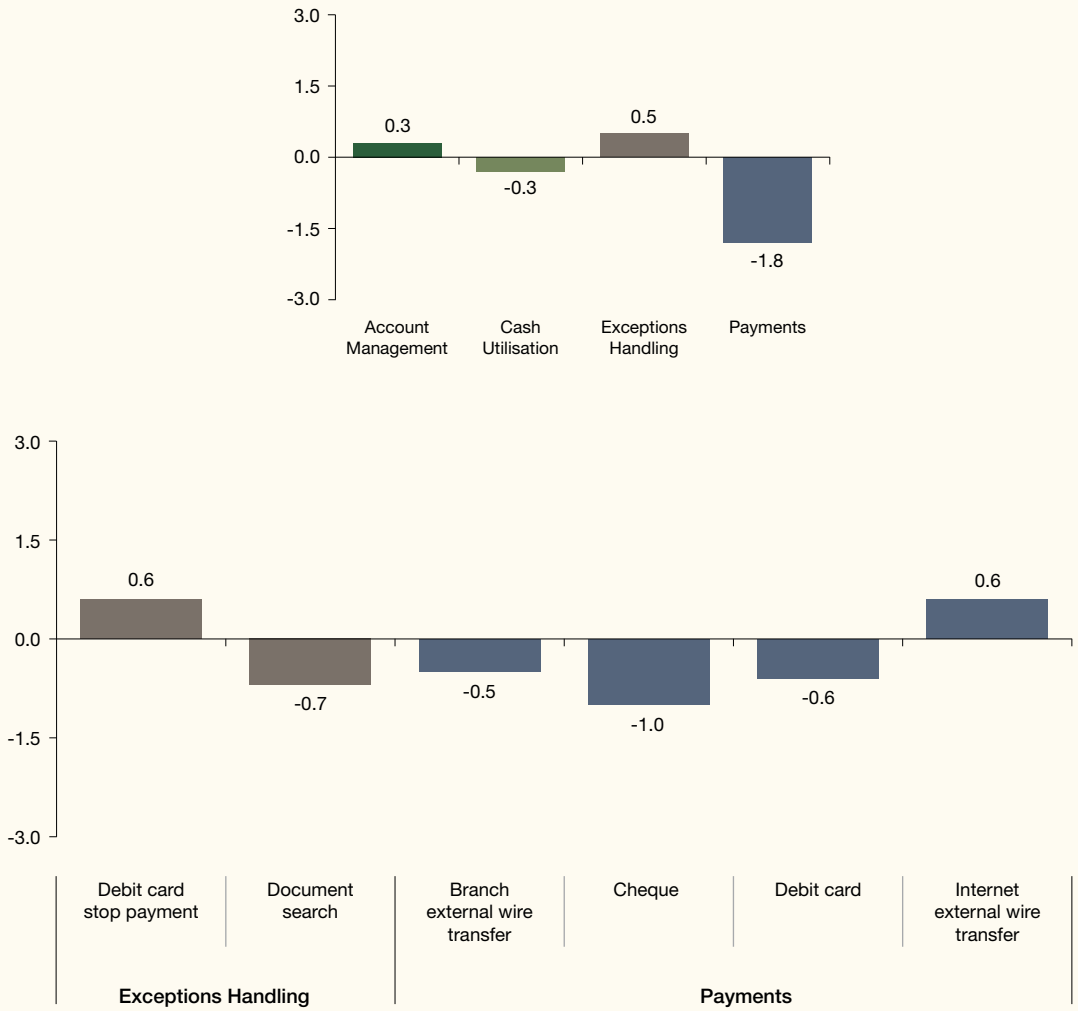


Source: Capgemini analysis, 2009.

The Asia-Pacific zone was, however, very heterogeneous, both in terms of prices and evolution. Consumers' habits differed a lot from one country to another.

Prices in Asia-Pacific fell by 2.3% (down €1.3) for local active users. The main change in the region's fee structure is the drop in payments fees (external transfers and cheques) (see Figure 1.21). This decline is in line with that of last year, driven primarily by India. It can be attributed to a steep fall in payments prices, especially the elimination of minimum service charges for branch external wire transfers.

FIGURE 1.21 **Product and Service Price Variations vs. Last Year for Local Active Users in Asia-Pacific (€)**



Source: Capgemini analysis, 2009.

CONCLUSION

This year's study confirmed three major trends observed over the past four years:

- **Prices continued to decline**: A 2% drop from last year, and a 1.2% annual decline since 2005.
- **Policies designed to encourage Internet usage were reinforced**: An Internet active user paid €9.5 less (16% lower) than a standard active user, and about €31 less (34% lower) than a branch active user.
- **Price convergence in Europe Eurozone and North America continued to increase**: Price discrepancies are at 31.7% (down from 32% last year) for Europe Eurozone and 27.4% for North America (down from 33.8%).

We believe these trends will continue: Along with the development of low-cost remote banks, and clear pricing encouraged by regulators and associations, the impact of the Internet and geographic price convergence will continue to make prices decrease for the next five years.

Banks will need to create value in new ways, notably through differentiation on offers and services: Two main forces will drive this challenge. First, banks will need to extend the scope of their activities to non-financial products (real estate, services, insurance, etc). Second, they will have to strengthen the added value they bring to clients by personalizing their customer approach and developing their advisory capacities.

Nevertheless, the heart of the retail banking business must be conserved: Although revenues will decrease in the short term, successful banks will bear in mind that core banking activities are the backbone of their relationship with their clients.

MANAGING MORTGAGE PROFITABILITY

RETAIL BANKS AT A CROSSROAD IN 2009

Principal Findings

1. The Booming Mortgage Market, 2001-2007

- Mortgage was a growth engine for retail banks worldwide from 2001 through 2007, with some markets exceeding reasonable limits, especially in the ratio of mortgage debt to gross domestic product.
- Although most mortgage markets experienced this boom, huge discrepancies could be observed between these markets.
- Within each of these markets, retail banks developed similar commercial and economic strategies. Depending on the country, mortgage was used either as a *stand-alone* product (it has to be profitable by itself), a *hook* product (it is used primarily for customer acquisition and is sold with low margins), or a *hybrid* product (it serves customer acquisition objectives, but with margins that aim at a profitable return).

2. Mortgage Unit Profitability: A Widespread Decline until 2007, Partly Mitigated by Growth

- Unit profitability declined from 2003 through 2007, primarily as a result of the decrease in net interest income (down by around 50 basis points [bps] in major markets) due to intense competition between retail banks.
- Initiatives to generate additional revenues and reduce costs could not compensate for the loss in interest revenues.
- This decline in global unit profitability was partly mitigated by the rise in volume during this period, but value creation remained questionable.

3. The Year 2008: A Downward Turning Point in the Mortgage Market

- In 2008 the subprime crisis marked a clear stop to positive trends in the mortgage market, with an explosion in funding costs having a dramatic impact on mortgage profitability.
- In the five years to come, retail banks will need to prepare for a significant decline in mortgage activities due to three main factors: the general slowdown of the world economy, the asset crisis with its impact on the cost of funding, and the threat of an increasing cost of risk.
- The general trend towards regulations protecting consumers (for example, limits on loan prepayment penalties and ceilings on total customer rates) is likely to continue, and will have an impact on mortgage unit profitability.

4. How Can Retail Banks Respond to the New Market Situation?

- Banks are looking for key opportunities and activities to address the challenges related to this new market situation over the next five years.
- For marketing and sales:
  - Improve mortgage sales productivity and capabilities by enhancing cross-selling and, where there is critical mass, developing a specialised sales force.
  - Develop new products and services by focusing on higher margin services linked to mortgages and by creating packages with other financial products.
  - Use remote channels by reinforcing their position as pre-sales and sales channels.
- For pricing and risk-management issues:
  - Optimise pricing strategies by developing customer-based pricing, aware that any of today's customer spreads would not even cover the cost of funding.
  - Manage risk by improving customer selection processes and tools, and by enhancing approaches to monitoring the loan portfolio (early-warning and watch-portfolio approaches, customer category-related actions, etc).
- For middle/back office and information technology (IT) optimisation:
  - Optimise origination and servicing by speeding up the loan origination processes and by lowering the breakeven point, notably through geographic consolidation.
  - Optimise IT, also mainly by geographic consolidation.
- Among these key opportunities, the most critical are improving mortgage sales productivity and capabilities, and optimising pricing strategies.

5. Moving Forward over the Next Five Years

- In 2009, retail banks are at a crossroad and will have to make major changes to remain successful over the next five years:
  - Rather than relying exclusively on cost reduction, the best retail banks will continue to develop sales, particularly by improving cross-selling capabilities, product bundling, and customer-based pricing.
  - Top-performing retail banks that once relied on *hook* or *stand-alone* strategies will have to alter their approaches in favour of the *hybrid* strategy.
  - Retail banks will also have to rethink their business models and revert to their historic deposit-based approach, leaving behind the credit-based model of the past few years.
- In this crisis context, mortgage specialists' ability to survive on their own is weak, due to the lack of access to deposits and direct cross-selling opportunities.
- Managing mortgage profitability by developing excellent profitability models is the clear way forward, although today it is an under-used practice. We believe it is the best way for retail banks to ensure they are prepared for the daunting challenges they will face in the years ahead.

METHODOLOGY

We based our Spotlight analysis on three different investigations: a market survey, a qualitative bank survey, and an in-depth profitability analysis.

We completed the market survey to describe most effectively the role mortgages played in ten target countries: eight in Europe (Austria, France, Germany, Italy, the Netherlands, Poland, Spain, and the United Kingdom), as well as the United States and Japan.

In the qualitative bank survey, we questioned executives in fifty-four large retail banks in seventeen selected countries (listed in Figure 2.7) to get a complete picture of their mortgage profiles (see Figure 2.1).

Our primary goal was to understand retail banking's potential profitability over the next five years, and find ways to improve this profitability. Each bank was asked questions in three areas: (1) their key figures, profitability measurements, and their evolution and regulations affecting them; (2) the role mortgages played at their institution; and (3) key opportunities they foresaw for the next five years.

For the profitability analysis, we identified two large, international banking institutions in two different countries (we do not name them to maintain agreed confidentiality). We conducted exhaustive examinations of their mortgage processes and perspectives to obtain a complete picture of their profitability.

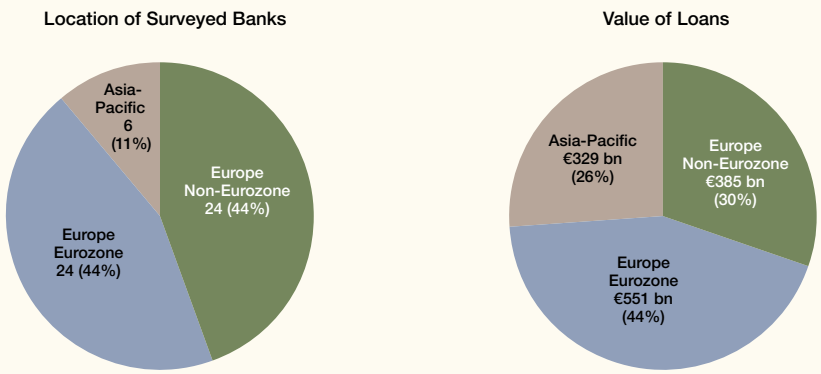
Our objective was to calculate and compare the net present value (NPV) of net operating profit after tax (NOPAT), and the NPV of the economic value added (EVA) for loans originated in the past five years.

We began by defining a "standard loan" for each bank, and identified four elements of each loan over its entire duration:

- Revenues (such as net interest income, fees, insurance margin)
- Cost of risk
- Operating costs (distribution, origination, servicing, IT)
- Cost of capital employed

Based on this methodology, we developed our Spotlight in five parts, beginning with a review of mortgage markets over the past five years, and ending with our view of retail banks' most effective way forward in the future.

FIGURE 2.1 **Breakdown of Banks in Qualitative Survey, by Geographic Area and Value of Loans (Outstanding Balances, 2007)**



Source: Capgemini analysis, 2009.

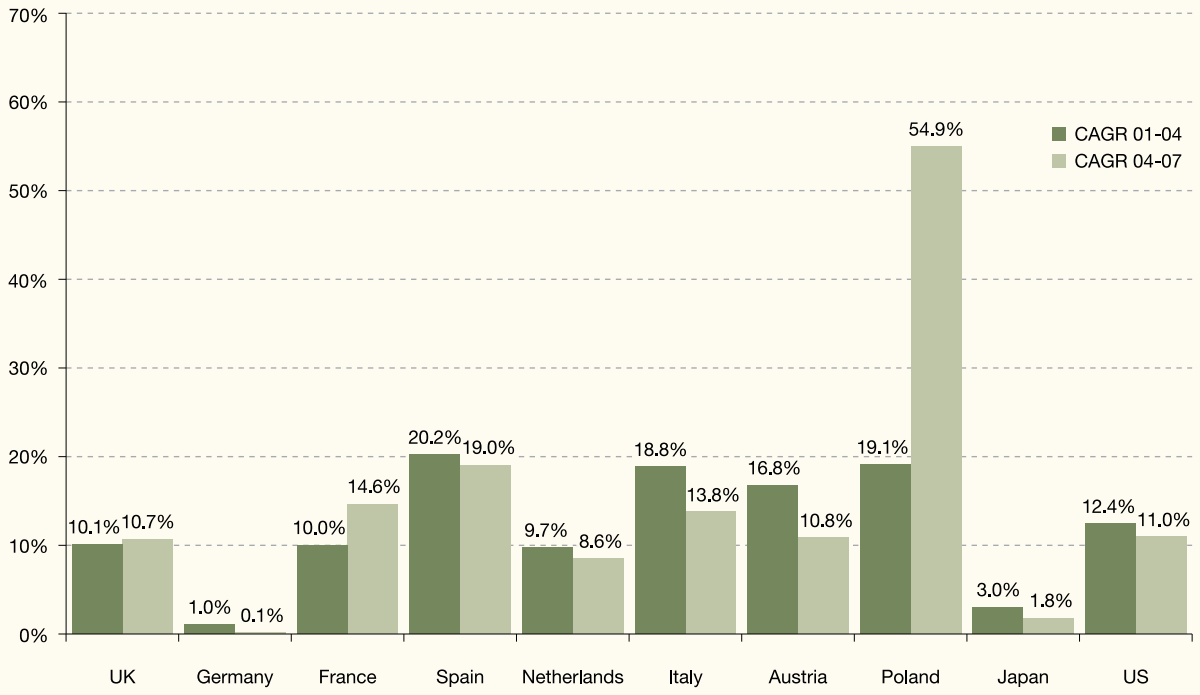
1. THE BOOMING MORTGAGE MARKET, 2001-2007

Mortgage was a growth engine for retail banks worldwide from 2001 through 2007. In the vast majority of countries, the compound annual growth rate (CAGR) for mortgage outstanding balances was above 10% for this period (Figure 2.2).

Moreover, mortgages are a crucial product for economies in general and for retail banks in particular. Mortgages were a key financial product in most countries we studied, with ratios of mortgage outstanding balance to gross domestic product (GDP) above 20% (see Figure 2.3). Some markets exceeded reasonable limits, with ratios over 60%, notably the US, the UK, and Spain.

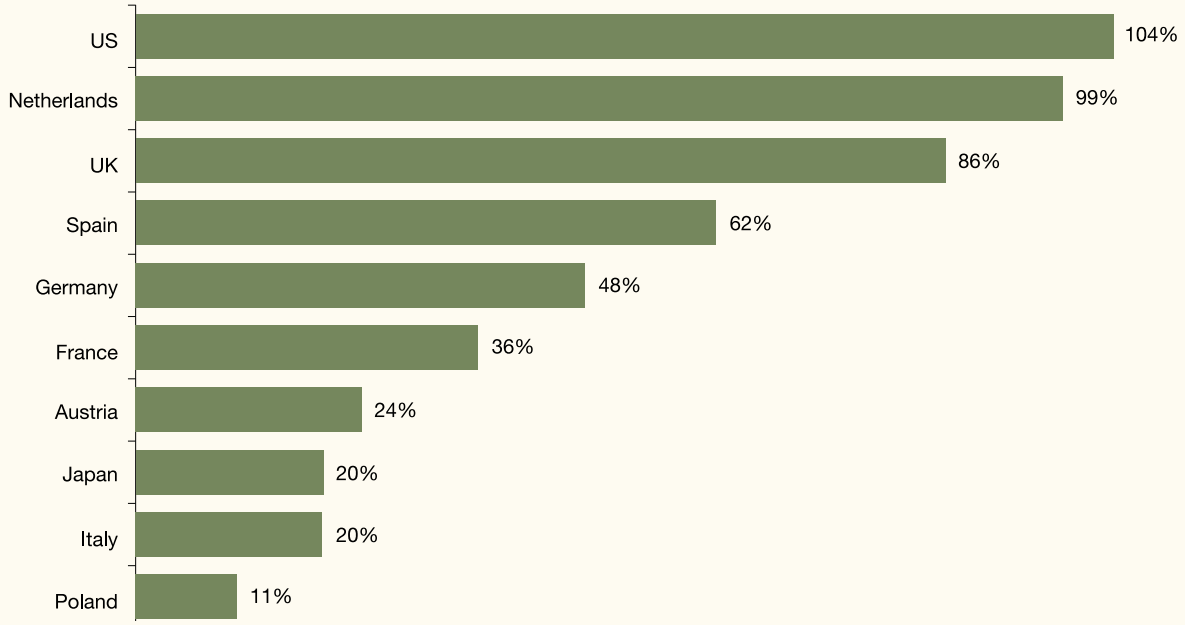
The main explanation for these high mortgage debt to GDP ratios lies in the uncontrolled increase in housing prices, and the associated asset risks. In the US, for example, the House Price Index (HPI) increased more than three-fold from 1985 through 2007 (see Figure 2.4).

FIGURE 2.2 **Mortgage Market Growth, Outstanding Balances, 2001-2007 (CAGR)**



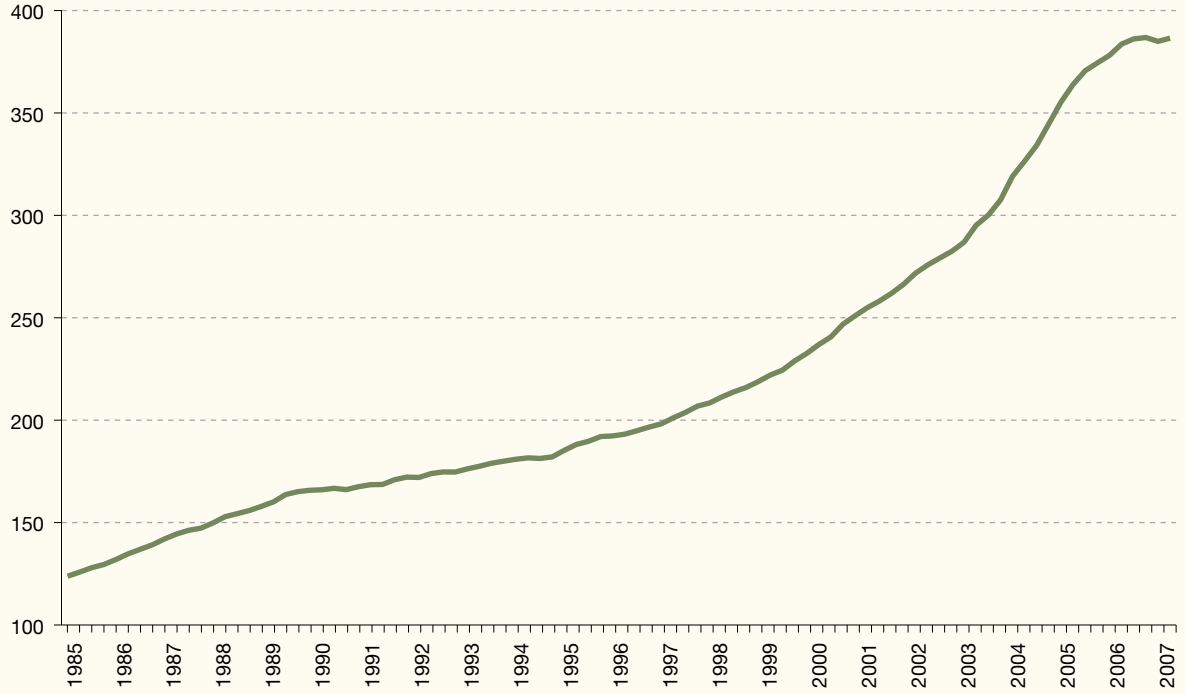
Source: EMF, Bank of Japan, Bank of England, US Census Bureau, Federal Reserve.

FIGURE 2.3 **Mortgage Outstanding Balances as a Percentage of GDP, 2007**



Source: EMF, Bank of Japan, US Census Bureau, Federal Reserve, Dutch National Bank, National Bank of Poland, Capgemini analysis, 2009.

FIGURE 2.4 **United States House Price Index (HPI), 1985-2007**



Source: Federal Housing Finance Agency.
Note: 1980 Q1 = index 100.

As Figure 2.5 indicates, the importance of mortgage loans is also reflected in retail banks' balance sheets. For most countries, mortgage outstanding balances were 15% or higher than their total banking assets.

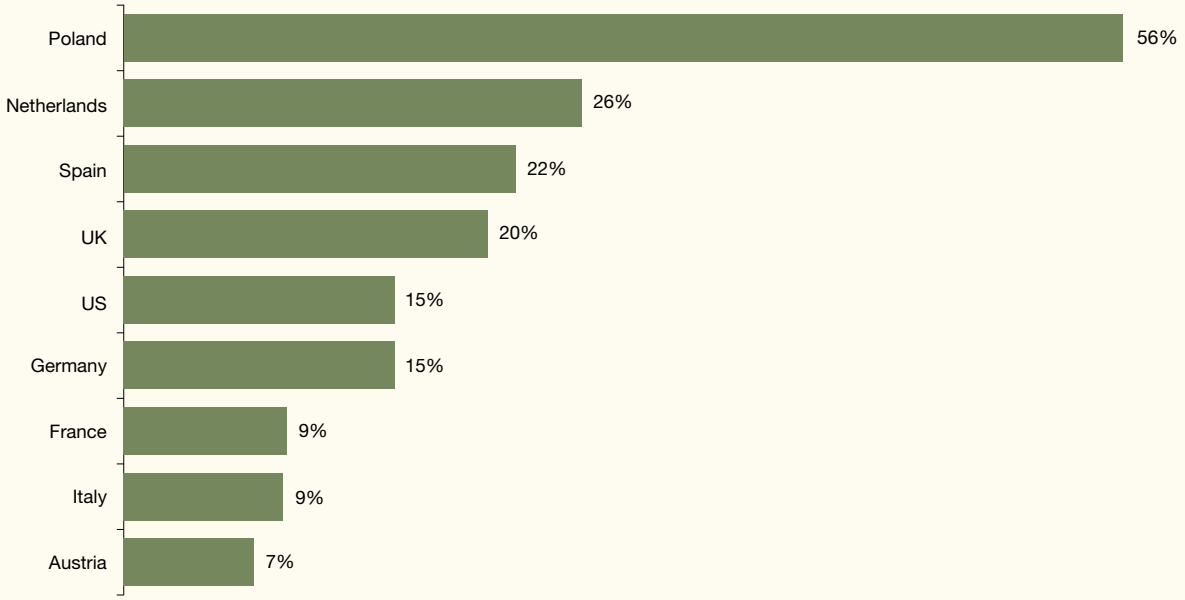
Mortgages represent a significant portion of a retail bank's customer portfolio and net banking income (NBI). For the banks we studied, an average of 12% of customers had a mortgage, and mortgages accounted for 20% of a bank's net banking income.

Although most mortgage markets experienced this boom, huge discrepancies could be observed between these markets. Mortgage markets differ greatly from one country to another in terms of debt, loan types, interest rates, market concentration, and distribution channels, as shown in Figure 2.6.

Several notable differences emerged:

- As noted above, in 2007 the ratio of mortgage debt to GDP was quite high in the US, the UK, and to a lesser extent, Spain, all countries highly exposed to the current real estate and financial crisis. This ratio was also elevated in the Netherlands, partly as a result of tax regulations encouraging customers to borrow.
- In terms of loan types, floating rate loans largely dominated in Japan, Spain, and Italy, while fixed interest rate loans prevailed in other countries.
- In 2008, interest rates ranged from less than 180 bps (Japan) to 780 bps (Poland), with most countries having between 450 and 610 bps.
- Market concentration (measured as the market share of outstanding balances of the top five banks) varied greatly from one country to another. Germany is not very concentrated, while Poland and Austria are quite concentrated. Concentration is intermediate in the other countries, with a first cluster at about 55% (Japan, the US, the UK, Spain, and Italy) and a second at about 70% (the Netherlands and France).
- The mix of distribution channels is also very specific from one country to another. In Japan, France, Germany, Poland, and Italy, retail banks rely mainly on direct channels (branches, online bank channels, tied agents) for mortgage distribution, while in Spain, the Netherlands, and the UK, retail banks distribute mortgages (in priority) through indirect channels, including real estate agents, third parties, independent financial advisers, and other independent mortgage actors. These last three countries also have the highest mortgage debt to GDP ratios.

FIGURE 2.5 **Mortgage Outstanding Balances as a Percentage of Retail Banking Assets, 2007**

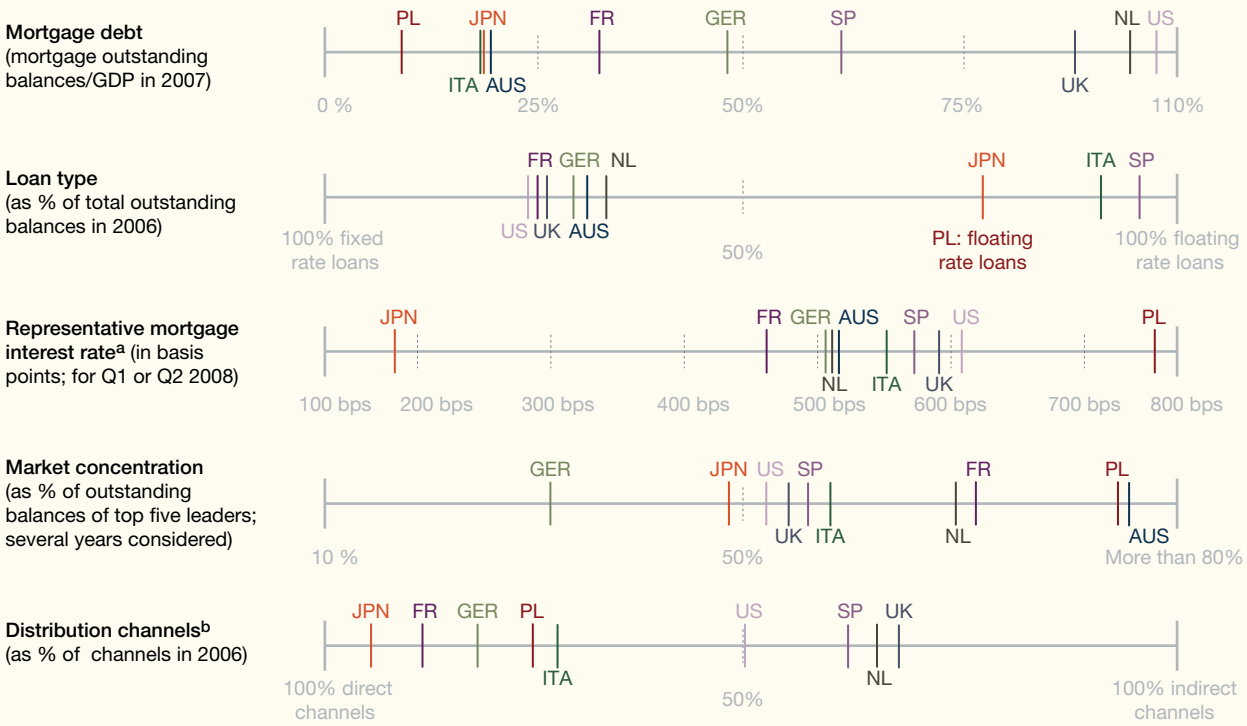


Source: EMF, US Census Bureau, Federal Reserve, Dutch National Bank, National Bank of Poland, Capgemini analysis, 2009.
Note: 2006 data for Poland.

Mortgage regulations and tax issues also differ greatly from one country to another. In addition to shared international and European regulations, such as Basel II, each local mortgage market is ruled by specific local laws and regulatory systems. These peculiarities can be seen in prepayment policies and tax deductions, as well as in lending insurance or debt policies.

In Italy, for instance, prepayment fees were removed recently, weakening the retention effect of mortgages. In 2006, the French government authorized a zero percent interest rate to encourage property ownership. In the Netherlands, the *Mortgage Financing Code of Conduct*, focusing on transparency and "duty to care" about the customer, governs the mortgage market. This code is a market agreement by mortgage actors with government supervision.

FIGURE 2.6 **Mortgage Markets Differ Significantly by Country**



Source: EMF, US Census Bureau, Bank of England, Bank of Japan, National Bank of Poland, Dutch National Bank, BCE.

Note: AUS: Austria, FR: France, GER: Germany, ITA: Italy, JPN: Japan, NL: Netherlands, PL: Poland, SP: Spain, UK: United Kingdom, US: United States.

[a] The representative mortgage interest rates are an average of specific mortgage rates for first ranking mortgages, involving no prior savings, with no discounts included, gross of tax relief, net of other bank costs (EMF definition).

[b] N/A for Austria.

Within each of these markets, retail banks developed similar commercial and economic strategies. Depending on the country, mortgage was used either as a *stand-alone*, *hook,* or *hybrid* product (see Figure 2.7):

- Mortgage as a *stand-alone* product: Retail banks offer mortgages the way a mortgage specialist would; the product has to be profitable by itself.
- Mortgage as a *hook* product: Mortgage is used primarily for customer acquisition, leading to profitable cross-sales, and is sold with low margins.
- Mortgage as a *hybrid* product: Retail banks consider mortgage as a product for customer acquisition, but with margins that aim at a profitable return.

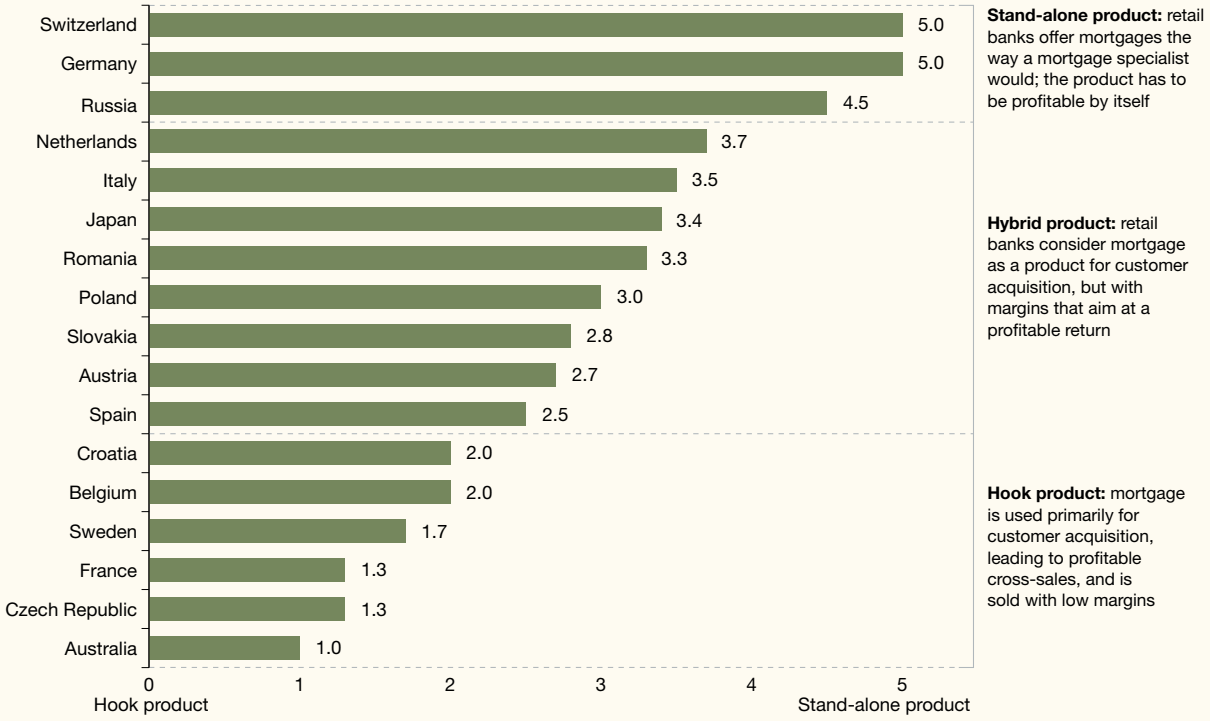
In two-thirds of the countries we investigated, retail banks mainly follow *stand-alone* or *hybrid* strategies, in which a mortgage must be profitable, not just a tool for cross-selling. In these countries, managing mortgage profitability is essential.

In countries where the *hook* strategy is the rule, selling mortgages at low margins is seen as a commercial investment. Nonetheless, effective retail banks here monitor their mortgage profitability to evaluate investment costs, much as they do for their other commercial and marketing investments.

2. MORTGAGE UNIT PROFITABILITY: A WIDESPREAD DECLINE UNTIL 2007, PARTLY MITIGATED BY GROWTH

Unit profitability declined from 2003 through 2007, primarily as a result of the decrease in net interest income (down by around 50 bps in major markets) due to intense competition between retail banks. During this period, most banks were primarily seeking to defend or develop their market shares, using aggressive commercial policies. As a result, the unit profitability of a mortgage product decreased over the last five years. As Figure 2.8 indicates, in the majority of the banks we surveyed (61%), mortgage unit profitability decreased either strongly or slightly

FIGURE 2.7 **Mortgage Strategies, by Country**



Source: Capgemini interviews with 54 surveyed retail banks, 2009.

Note: Respondents were asked to assign a number from 1 to 5 to characterise the role of mortgages in their institutions, with 1 meaning they treat mortgages solely as hook products, and 5 meaning they treat them solely as stand-alone products.

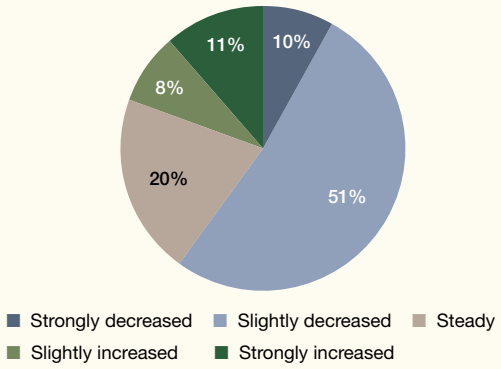
from 2003 through 2007. These changes are not necessarily the result of country-wide patterns; within one country or another we found great variations in the banks' responses.

Despite the global trend towards declining profitability, Figure 2.8 also indicates that 20% of all banks surveyed reported an increase in unit profitability. Most of these respondents are based in Eastern Europe and Russia, however, and started their mortgage activities in the early 2000s. For these banks, the profitability increase is directly related to the bankers' movement up the experience curve and economies of scale. In addition, one bank (in Europe Eurozone) cited a wide productivity program (new registration application, branch efficiency).

The two in-depth case studies we conducted confirmed the finding that average mortgage unit profitability declined (see Figure 2.9).

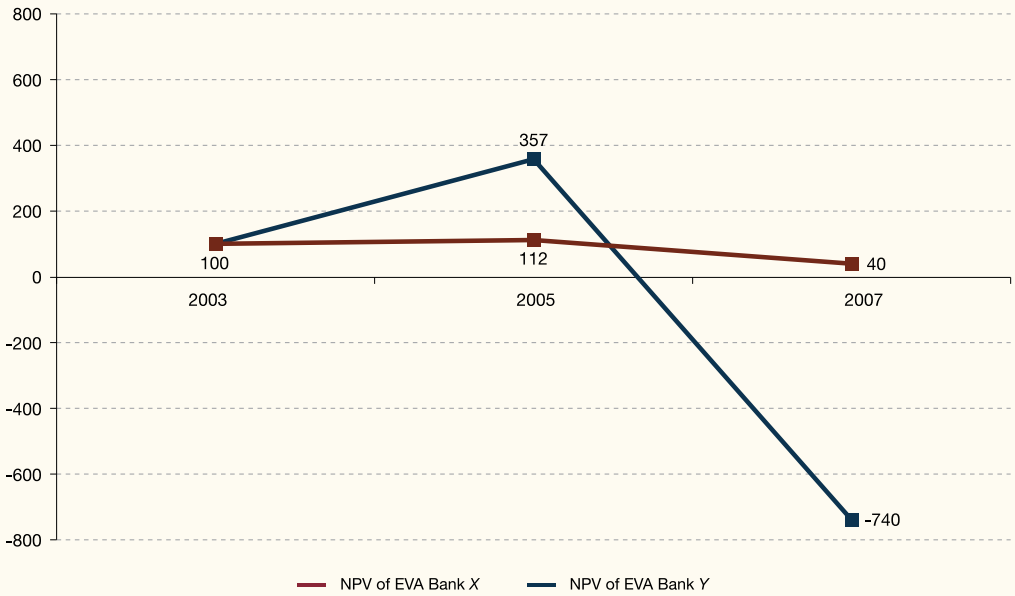
For the first bank (Bank *X*), the net present value (NPV) of the economic value added (EVA) per loan originated decreased by 40% between 2003 and 2007; for the second (Bank *Y*), profitability decreased even more precipitously, becoming largely negative. For this bank, loans made in 2007 will have a negative impact on contribution over their entire duration.

FIGURE 2.8 **Mortgage Unit Profitability, 2003-2007 (%)**



Source: Capgemini analysis, 2009.

FIGURE 2.9 **Case Studies: Evolution of Mortgage Profitability, 2003-2007**

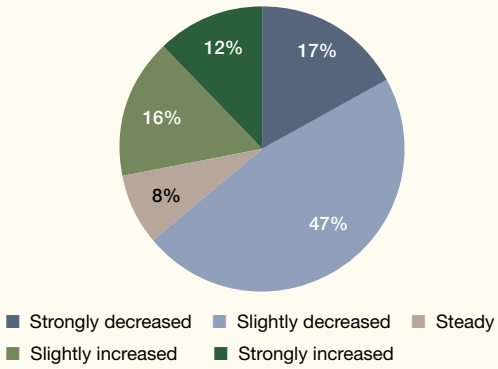


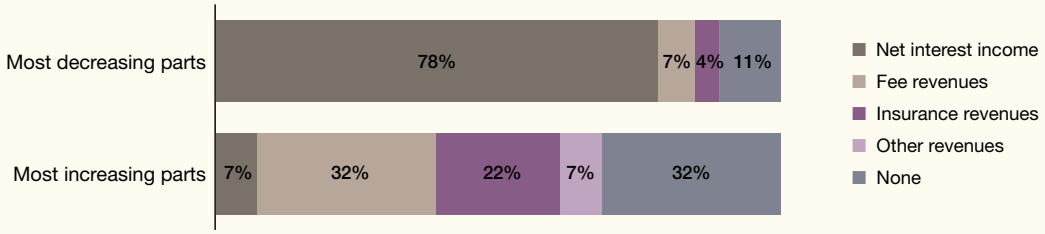
Source: Capgemini analysis, 2009.
Note: Unit profitability of a standard loan expressed as NPV of EVA. Data are shown on an index basis, specific to each bank, where index 100 corresponds to the value of the NPV of EVA for a loan originated in 2003.

The overall global unit profitability decline can be explained by the decrease in revenues, notably net interest income (see Figure 2.10). Most bank executives in our survey told us that their revenues have decreased over the past five years. Almost 80% viewed net interest income as the fastest decreasing part of their revenues.

The case study findings were confirmed by the gross interest margin evolution observed in several markets. From 2003 through 2007, the average gross interest margin declined from 1.33% to 0.80% (53 bps) (see Figures 2.11 and 2.12).

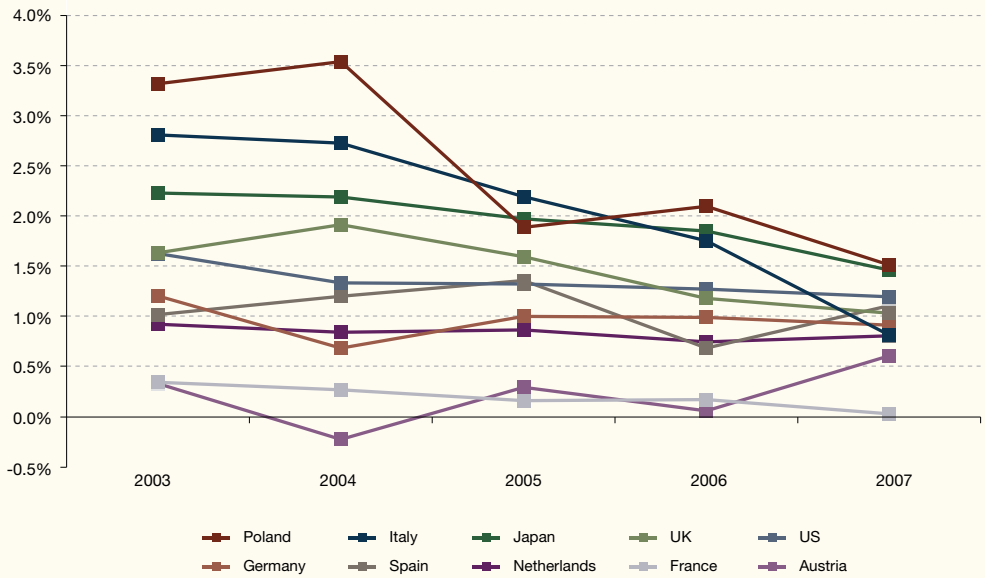
FIGURE 2.10 **Mortgage Unit Revenue Performance, 2003-2007 (%)**





Source: Capgemini analysis, 2009.

FIGURE 2.11 **Changes in Mortgage Gross Interest Margins, by Country, 2003-2007 (%)**

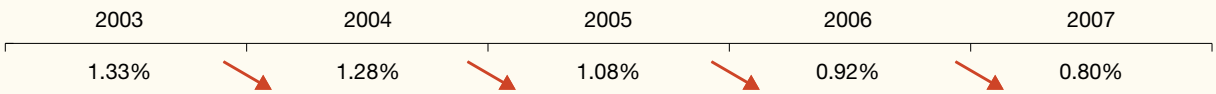


Source: Bank Source: EMF, BCE, Bank of Japan, Bank of England, Federal Reserve, National Bank of Poland, Bloomberg, Capgemini analysis, 2009.
Note: The mortgage gross interest margin is the difference between the interest rate for customers and relevant local index rates:
- Euribor 1 year for the following European countries selling mainly variable rate loans: Spain and the UK.
- Euribor 3 months: Italy.
- A mix of Euribor 3 months and Wibor 3 months: Poland.
- LIBOR 3 months in Japanese yen: Japan.
- Government bonds (10 years): European countries selling mainly fixed rate loans.
- Swap rate: United States.

As a consequence, banks have developed other sources of revenue (notably fees and insurance margins), but not enough to compensate for the loss in net interest income (see Figure 2.10).

Initiatives to generate additional revenues and reduce costs could not compensate for the loss in interest revenues. A large majority of banks (72%) reported that over this same period their operating costs remained either steady or, when decreasing, did not decline enough to compensate for their revenue losses (see Figure 2.13).

FIGURE 2.12 **Decline in Average Mortgage Gross Interest Margin, 2003-2007 (%)**

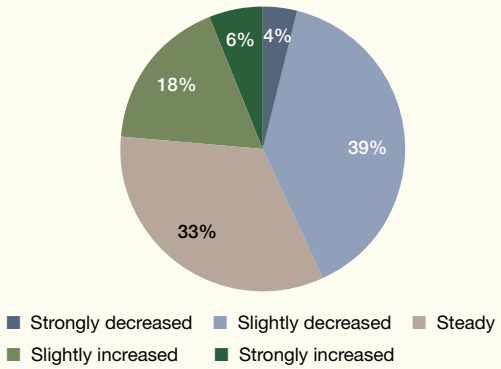


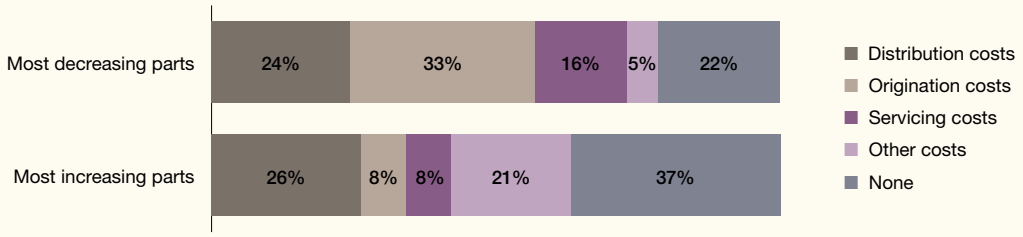
Source: EMF, BCE, Bank of Japan, Bank of England, Federal Reserve, National Bank of Poland, Bloomberg.
Note: Countries considered included Austria, France, Germany, Italy, Japan, the Netherlands, Poland, Spain, the UK, and the US.

Of all operating costs, origination and servicing costs combined (notably underwriting and recovery) have decreased the most. Nevertheless, as opposed to revenue trends, where interest evolution clearly drives a pattern of decline, costs exhibit a less obvious pattern, as they depend to a greater extent on each bank's strategy rather than macroeconomic factors.

Moreover, those banks that were able to reduce costs were found in different markets and had different sizes and structures. Depending on the maturity of the market in which the bank was situated, this phenomenon can be explained in most cases either by experience curve effects (emerging markets) or by structured productivity programs (more mature markets).

FIGURE 2.13 **Mortgage Unit Operating Cost Performance, 2003-2007**

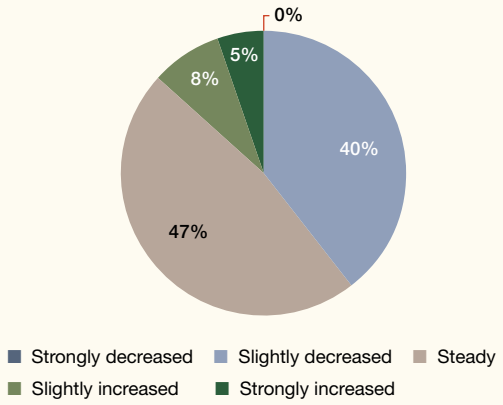




Source: Capgemini analysis, 2009.

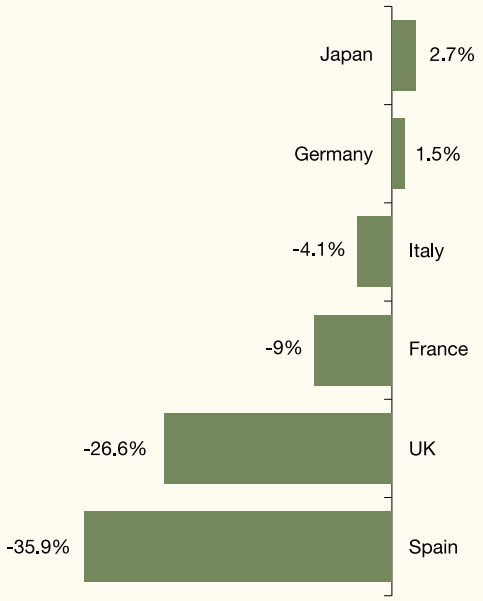
More than 80% of the banks we surveyed reported that the cost of risk decreased or stayed steady over the past five years (see Figure 2.14). Nevertheless, since 2007 the cost of risk has risen in retail banks for newly originated loans.

FIGURE 2.14 **Cost of Risk, 2003-2007 (%)**



Source: Capgemini analysis, 2009.

FIGURE 2.15 **General Decline in Mortgage Growth, H1 2007 vs. H1 2008, by Country (%)**



Source: EMF, Bank of Japan, Bank of England.

In most countries we studied, this decline in global unit profitability was partly mitigated by the rise in volume observed during this period, but value creation remained questionable. This was especially true for banks developing *hook* product strategies, where mortgage market share and customer acquisition were key objectives. Yet this strategy is not durable over the long term, because without market growth, as is the case today, trade-offs between market share and unit profitability no longer work.

3. THE YEAR 2008: A DOWNWARD TURNING POINT IN THE MORTGAGE MARKET

In 2008 the subprime crisis marked a clear stop to positive trends in the mortgage market, with an explosion in funding costs having a dramatic impact on mortgage profitability. This crisis was principally generated by the brutal downturn in US housing prices in early 2008. The risky, high-volume trades in real estate loans sparked a global crisis whose effects are still difficult to measure. Among the first victims were US mortgage giants Fannie Mae and Freddie Mac, taken over by the US government on 8 September 2008, closely followed by the venerable investment bank Lehman Brothers Holdings Inc, which filed for bankruptcy on 15 September.

From the beginning of 2008, the world economy had begun to show signs of crisis, as illustrated for the mortgage market in Figure 2.15. When analysing the gross advances between first half (H1) 2007 and H1 2008, volumes declined in all major markets except Germany and Japan, the two slowest-growing mortgage markets of our survey.

Since the beginning of the crisis, the cost of funding has exploded, dramatically affecting mortgage profitability of retail banks. As Bloomberg reported, this huge increase can be observed by comparing January 2009's five-year Senior Credit Default Swap (CDS) with what it was before the subprime crisis for the twenty top listed European banks. In June 2007—before the subprime crisis—the five-year Senior CDS was 8 bps on average, but by January 2009, it had reached 150 bps, for a 142 bps rise in eighteen months. This rise was even higher (up 179 bps) for the ten hardest-hit banks.

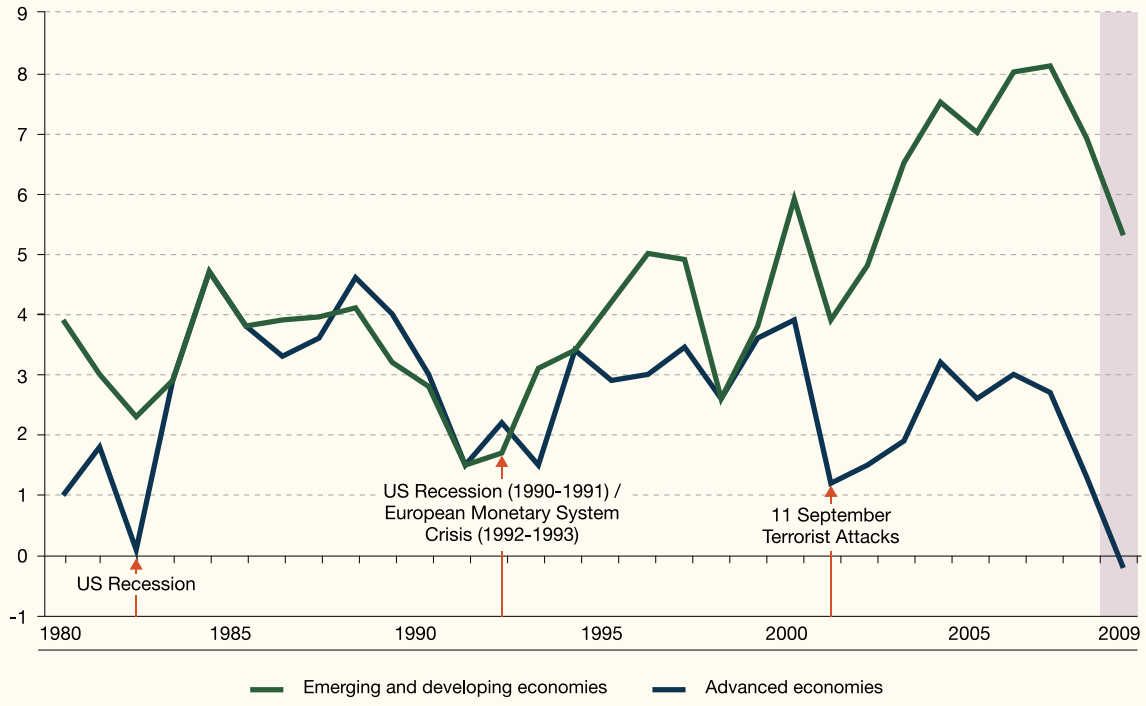
In the five years to come, retail banks will need to prepare for a significant decline in mortgage activity due to three main factors: the general slowdown of the world economy, the asset crisis with its impact on the cost of funding, and the threat of an increasing cost of risk. At the beginning of January 2009, the International Monetary Fund (IMF) announced that it would "significantly" increase its projection of losses and withdrawals due to the crisis, previously established at $1.4 trillion. The IMF's projections for the 2009 fiscal year are grim. Globally, the world economy is set to grow by only 2.2% (down from 3.7% in 2008 and 5.0% in 2007), fuelled primarily by still positive growth levels in emerging countries.

All signs point to a significant and widespread economic slowdown in the years to come. Figure 2.16, taken from the *IMF World Economic Outlook 2008* (updated version), illustrates the various financial ups and downs of the past thirty years. As the figure shows, the normal period of recovery time from a crisis or recession is three or four years. But no one can predict the length of recuperation time necessary for any financial disaster, especially one of the current magnitude. Nonetheless, if history is any guide, previous declining cycles indicate that a recovery process is not likely to begin before 2011. This global economic slowdown will be accelerated by the decline in the mortgage business itself, which will create a vicious circle, with impacts on the real estate and construction businesses that are key contributors to GDP creation.

A marked lack of assets will be another hallmark of the next five years. The ability to free up capital, so crucial to lending activities, will be even more seriously constricted by the implementation of Basel II, which will force banks to increase their capital on reserve. Cost of funding for banks is likely to remain high, even though the 2008 liquidity crisis might be over.

This lack of assets will affect all lenders, particularly the independent mortgage specialists who might not be able to survive on their own (an example is Interhyp, a leading German independent specialist, acquired by ING Direct in July 2008).

FIGURE 2.16 **Real GDP Growth and Trends (%)**



Source: *International Monetary Fund World Economic Outlook 2008* (updated version).

As many have observed since 2007, the cost of risk has risen—and not only in countries affected by the subprime crisis. In the process, retail banks we surveyed have become increasingly preoccupied by the threat of heightened risk in the years to come.

The recent years' general trend towards regulations protecting consumers (for example, limits on loan prepayment penalties and ceilings on total customer rates) is likely to continue, and will have an impact on mortgage unit profitability.

4. HOW CAN RETAIL BANKS RESPOND TO THE NEW MARKET SITUATION?

Banks are looking for key opportunities and activities to address the challenges related to this new market situation over the next five years. We asked surveyed banks to name their top opportunities for addressing the challenges related to this new market situation over the next five years. As Figure 2.17 indicates, they identified six key opportunities:

- **Three in marketing and sales:**
  - Improving mortgage sales productivity and capabilities
  - Developing new products and services
  - Using remote channels
- **One in pricing and risk:**
  - Pricing and risk management
- **Two in middle/back office and IT:**
  - Origination and servicing optimisation
  - IT optimisation

Among them, the Improving mortgage sales productivity and capabilities opportunity, and the Pricing and risk management opportunity, are the most important, having been cited by over half the surveyed banks (see Figure 2.17).

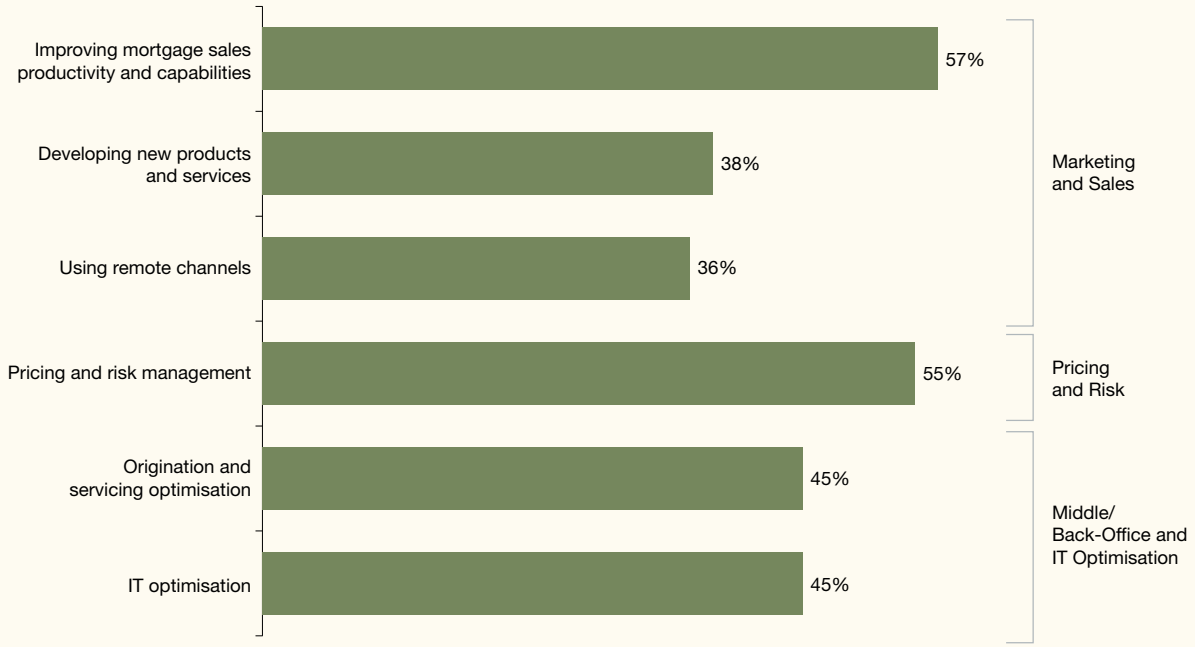
Other opportunities were proposed, such as developing intermediary channels and cross-border distribution, but these were not viewed as significant enough to warrant in-depth study here.

Marketing and Sales

Improving mortgage sales productivity and capabilities. Improving mortgage sales productivity and capabilities is the first overall and is considered a key opportunity in all regions. To capitalise on this major opportunity, retail banks saw the need to initiate three critical activities (see Figure 2.18):

- Improve cross-selling capabilities
- Develop a mortgage specialised sales force
- Intensify commercial management

FIGURE 2.17 **Key Opportunities to Address the New Mortgage Market Situation (% Respondents)**



Source: Capgemini interviews with 54 surveyed retail banks, 2009.

FIGURE 2.18 **Activities to Improve Sales Productivity and Capabilities over the Next 5 Years (% Respondents)**

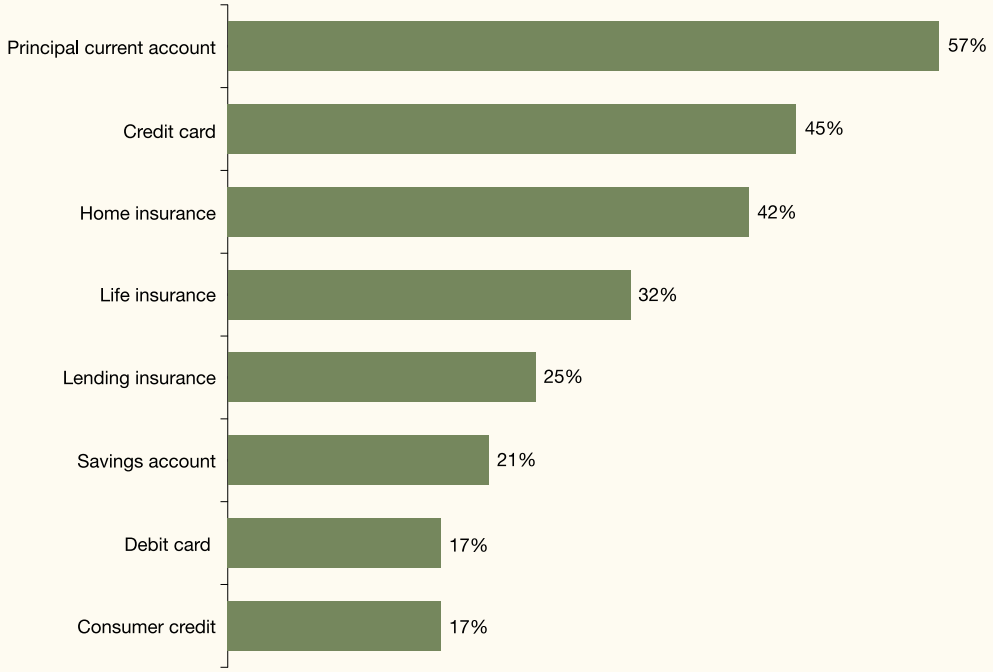
Source: Capgemini interviews with 54 surveyed retail banks, 2009.

Improving cross-selling capabilities is the most critical approach to improving sales productivity. A large majority of retail banks (nearly 80% of our respondents) aim to develop the cross-selling capabilities of their sales forces over the next five years. This is particularly notable because cross-selling policies related to mortgages are already widespread today.

Most responding banks have already developed cross-selling policies in the mortgage area. The main cross-sold products were principal current accounts and credit cards (see Figure 2.19). Insurance products (home insurance, life insurance, and lending insurance) were also often mentioned as cross-sold products.

Intensifying commercial management through planning and reporting processes and tools is a global lever for all retail banking activities, not just mortgage.

FIGURE 2.19 **Main Cross-Sold Products (% Respondents)**



Source: Capgemini interviews with 54 surveyed retail banks, 2009.

Executives in nearly 60% of the banks surveyed reported that sales force specialisation (with mortgage specialists) is important, and most have already initiated the process. This specialisation can be accomplished either by developing a specific sales force, or by implementing specialised call centres accessible both by customers (in addition to the Internet) and by the retail banking sales force (as an additional source of mortgage expertise). Nevertheless, some banks surveyed reported that in today's context of crisis, investing in new sales forces, with its additional costs, might not be relevant.

Developing new products and services. This activity was seen by many respondents as less important for the coming years than it has been for the past five, but it still remains a key opportunity in 38% of the banks where we interviewed (see Figure 2.17, above).

To capitalise on this opportunity, retail banks are focusing on three areas (see Figure 2.20):

- Develop non-financial products and services related to mortgage
- Create convergence/packages with consumer finance
- Innovate mortgage products

Developing non-financial products and services related to mortgages (such as home services and surveillance services) was viewed as an important activity in nearly half the banks we interviewed, with the objective of generating new revenues with higher margins than those offered by mortgages.

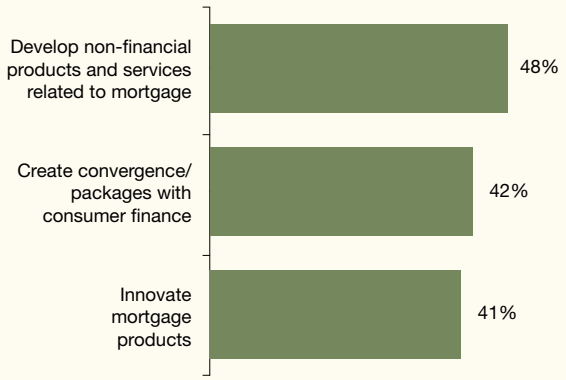
Creating packages with other financial products is another crucial area for this opportunity. Bank executives we interviewed cited consumer finance, as well as payment cards and insurance, as key products for packaging.

Mortgage product innovation is not considered to be as important as it has been for the past five years. Most retail banks believe that existing products respond to their customer needs. Yet some innovation will be done by simplifying or customising existing products, for example by increasing their flexibility (loan maturity, repayment policy, etc). Additionally, innovation will be used for niche products ("senior" mortgages, for instance).

Using remote channels. Using remote channels (such as the Internet and call centres) was the sixth opportunity overall, mentioned by 36% of the banks we surveyed. This opportunity has grown the most, with only 13% of banks we surveyed saying they had considered it important for the past five years.

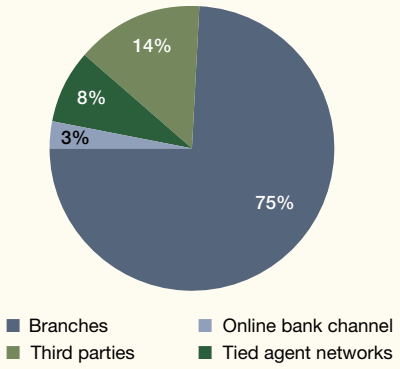
Remote channels are used today in the mortgage sales process, but principally as information channels. Sales through remote channels accounted for only 3% of mortgage sales in the banks we surveyed (see Figure 2.21).

FIGURE 2.20 **Critical Areas in Which to Develop New Products and Services (% Respondents)**



Source: Capgemini interviews with 54 surveyed retail banks, 2009.

FIGURE 2.21 **Mortgage Distribution Channels (% of Total Sales)**



Source: Capgemini interviews with 54 surveyed retail banks, 2009.

To capitalise on this opportunity, retail banks are considering two critical means (see Figure 2.22):

- Position remote channels as pre-sales channels for branches
- Position remote channels as sales channels

Executives in more than half the retail banks surveyed said they want to develop remote channels as pre-sales channels for branches. They would use these remote channels to achieve the first steps of the sales process—identify and select customers, and understand their needs. The sale itself would take place at the branch level, so that the bank could capitalise on the customer relationship at a key commercial moment.

Nearly 40% said they intend to develop remote channels as complementary sales channels to branches. In this case, the declared ambition is to sell 5%-10% of products through the Internet or call centres. This will be linked to the introduction of simplified offers.

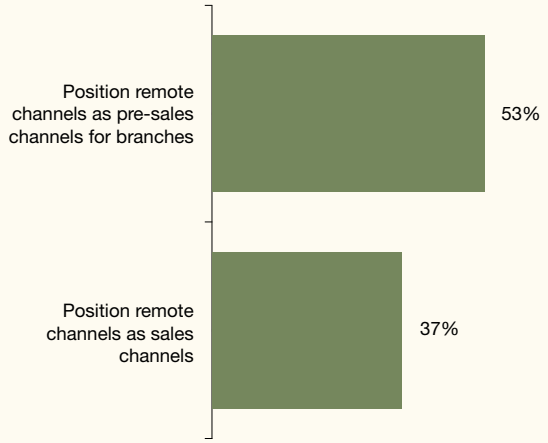
Pricing and Risk Management

Pricing and risk management is the second opportunity overall, and respondents in over half the banks surveyed cited this area as one of their top six opportunities over the next five years (see Figure 2.17, above). They were keenly aware that any of today's customer spreads would not even cover the cost of funding. They intend to take three primary actions to maximise the benefits from this opportunity (see Figure 2.23):

- Use customer-based pricing
- Improve customer selection processes and tools
- Enhance approaches to loan portfolio monitoring

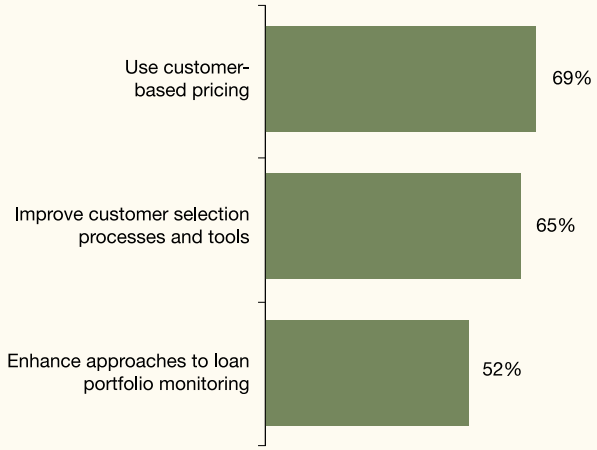
Successful retail banks will develop customer-based pricing while improving customer selection. Already, many banks often price their mortgage products using a mix of practices, including interest margin-based pricing, competition-based pricing, and customer-based pricing. Nearly 70% of responding banks told us that customer-based pricing is increasingly important in the context of Basel II, the capital squeeze, and increasing client risk. Retail banks intend to differentiate their pricing even more according to client risk and potential.

FIGURE 2.22 **Critical Means to Use Remote Channels in the Next 5 Years (% Respondents)**



Source: Capgemini interviews with 54 surveyed retail banks, 2009.

FIGURE 2.23 **Activities to Maximise Pricing and Risk Management over the Next 5 Years (% Respondents)**



Source: Capgemini interviews with 54 surveyed retail banks, 2009.

Risk management will remain a core mortgage practice and will be reinforced by the new market situation. Improving the customer selection processes and tools was cited as a primary lever in two-thirds of the banks surveyed, and credit risk management/monitoring (such as probability of default [PD], loss given default [LGD], internal ratings-based [IRB], and internal ratings-based approach [IRBA]) was viewed as essential by half of them.

Enhancing approaches to loan portfolio monitoring is also considered critical. The rising cost of risk, combined with greater difficulty in externalising risk through securitisation, poses new challenges for retail banks. Banks will need to remain vigilant concerning loan quality degradation on the balance sheet, avoiding the toxic combination of acquiring low-margin, high-risk ("bad") loans, and losing more profitable ("good") loans.

Banks will have to develop early-warning and watch-portfolio approaches to identify risky loans before they become non-performing. They will need to define and implement specific actions for each customer category to avoid degradation of the credit portfolio. Another way to address this new risk management challenge will be to mutualise it through specialised institutions, as is done today in some countries (for example, the *Credit Logement* institution in France).

Middle/Back-Office and IT Optimisation

Origination and servicing optimisation. This is the third opportunity overall, cited in 45% of the banks in our survey. We focused on each part of the mortgage value chain, as shown in Figure 2.24:

- We divided the origination process into four parts: product design, risk management, underwriting, and granting/cash transfer.
- We divided the servicing process into three parts: after-sales management, recovery, and litigation.

In 61% of surveyed banks, respondents considered the acceleration of the origination process as a major challenge that had to be met. They believe the capacity to make a loan quickly (e.g. two days) is a key success factor for sales. Accordingly, many banks have either already changed or aim to change tools in their front office (and often in their middle and back offices) to gain efficiency and speed.

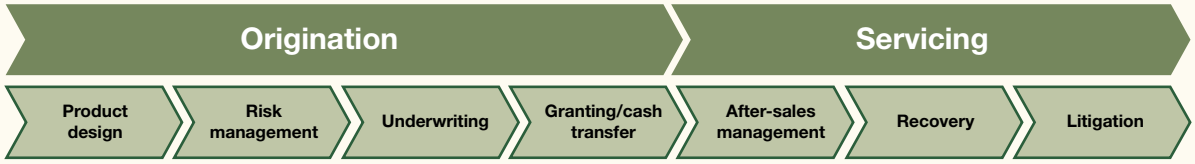
As Figure 2.25 indicates, respondents also cited actions to reduce operating costs and lower the breakeven point through organisation structure—geographic consolidation, synergies with other actors, offshoring, and outsourcing.

Geographic consolidation was the most cited lever, as it was for IT optimisation. Almost one out of every ten banks aims to develop multi-country middle and back offices over the next five years (see Figure 2.26).

One-third of retail banks surveyed said they hope to develop synergies with other institutions, mainly with other banks and mortgage specialists, but also with consumer finance institutions (see Figure 2.27). They would accomplish this either by sharing tools or even origination and servicing platforms, including human resources.

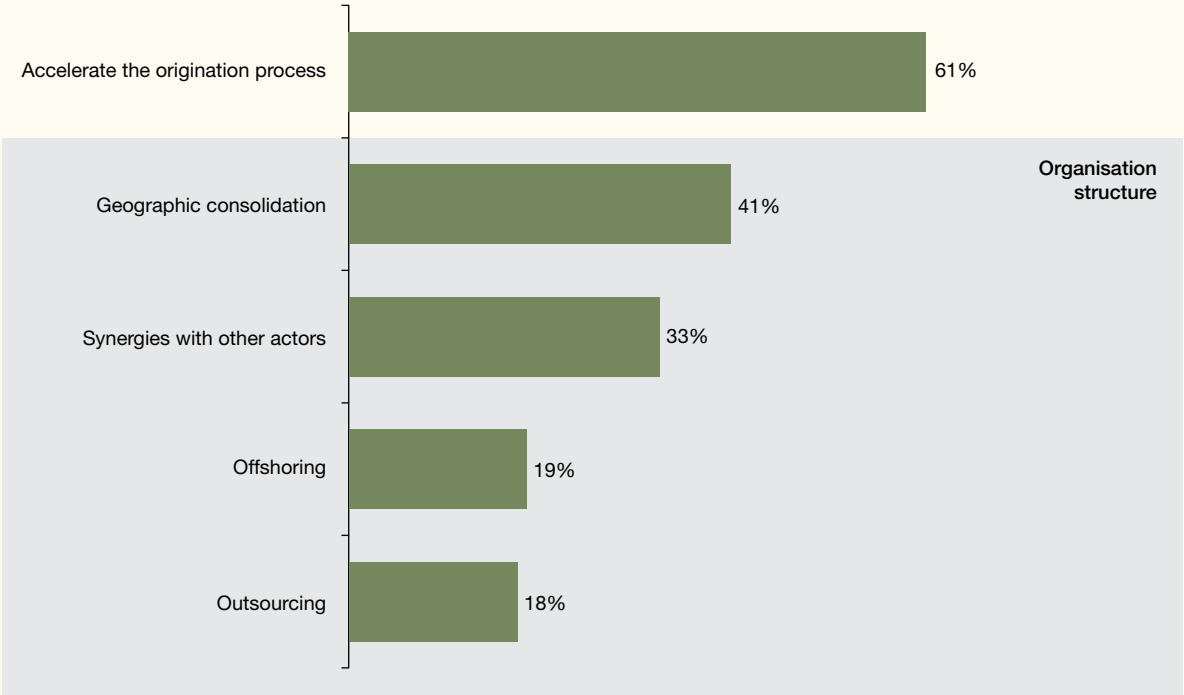
Outsourcing and offshoring were identified by only a few surveyed banks' respondents as areas where they thought their banks should take action (see Figure 2.25). While some leading retail banks have already capitalised in this area and will continue to do so, most consider the barriers to implementation, such as regulation and social and political issues, as simply too high.

FIGURE 2.24 **Mortgage Origination and Servicing Value Chain**



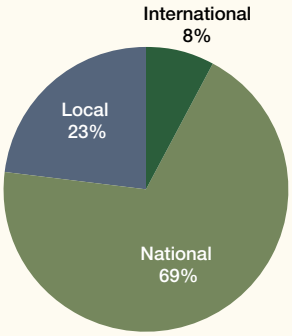
Source: Capgemini analysis, 2009.

FIGURE 2.25 **Ways to Optimise Origination and Servicing over the Next 5 Years (% Respondents)**



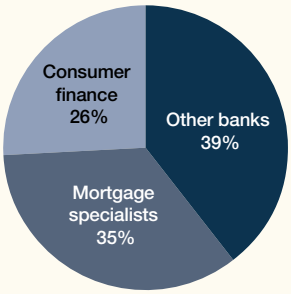
Source: Capgemini interviews with 54 surveyed retail banks, 2009.

FIGURE 2.26 **Levels of Origination and Servicing Geographic Consolidation for the Next 5 Years (%)**



Source: Capgemini interviews with 54 surveyed retail banks, 2009.

FIGURE 2.27 **Origination and Servicing Synergies with Others (% Respondents)**



Source: Capgemini interviews with 54 surveyed retail banks, 2009.

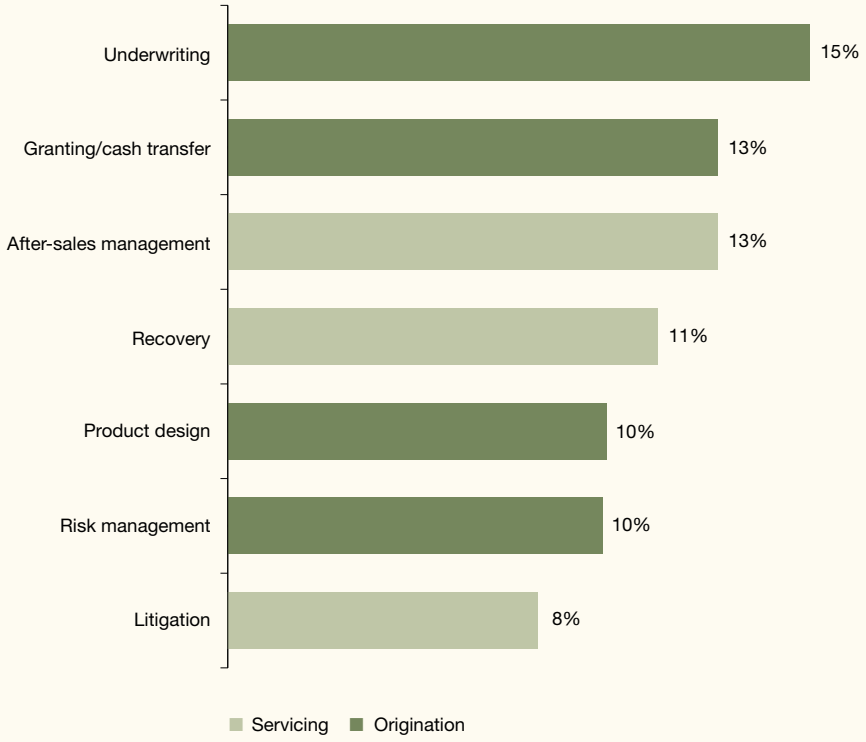
Altogether, organisation structure will affect all parts of the mortgage origination and servicing value chain (see Figure 2.28).

IT optimisation. IT optimisation is often a prerequisite for optimising origination and servicing, especially when considering organisation restructuring. For this opportunity, more than one-third of banks surveyed considered the optimisation of their IT on a geographic basis as critical (see Figure 2.29).

As Figure 2.30 illustrates, banks will strongly consider developing international IT systems (note the expected rise from 6% to 31%) in the five years to come. They expect this rise despite the fact that the national level will remain the primary consolidation level for mortgage IT over the next five years. To manage mortgages, most banks surveyed (77%) said they have an IT system at the national level, either for a part or all of their operations.

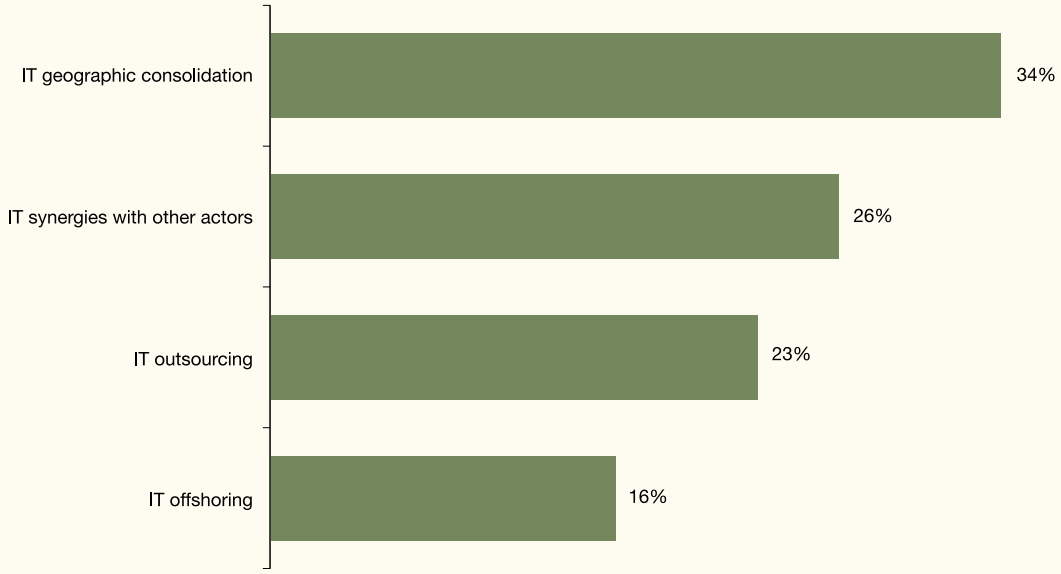
As for origination and servicing optimisation, other levers identified for IT optimisation are synergies with other actors (cited by one out of four banks), IT outsourcing, and IT offshoring (about one out of five banks).

FIGURE 2.28 **Changes in Origination and Servicing Value Chain (% Respondents)**



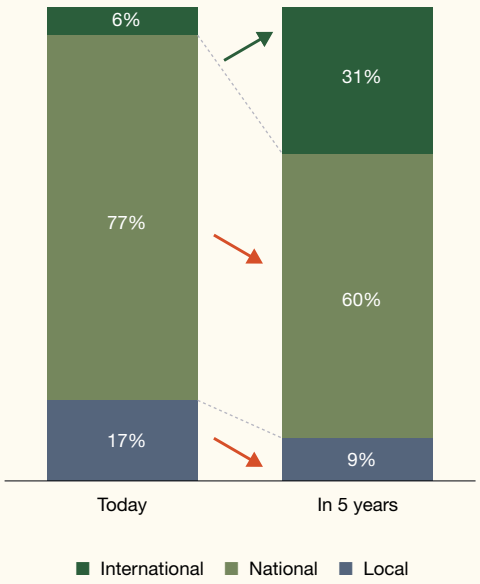
Source: Capgemini interviews with 54 surveyed retail banks, 2009.

FIGURE 2.29 **Ways to Optimise IT over the Next 5 Years (% Respondents)**



Source: Capgemini interviews with 54 surveyed retail banks, 2009.

FIGURE 2.30 **IT Consolidation, Today and in 5 Years (%)**



Source: Capgemini interviews with 54 surveyed retail banks, 2009.

5. MOVING FORWARD OVER THE NEXT FIVE YEARS

In 2009, retail banks are at a crossroad, and they will have to implement significant changes to remain successful over the next five years.

Rather than relying exclusively on cost reduction, retail banks should continue to develop sales. Reducing cost, primarily through geographic consolidation of middle and back offices as well as IT systems, should undoubtedly be a top priority for retail banks. Nevertheless, in the context of the current financial crisis, cutting costs is not a sufficient measure by itself, due to high fixed costs and uncertain revenue streams.

Banks should give equal priority to the development of their sales, particularly by improving cross-selling capabilities, product bundling, and customer-based pricing. Retail banks might also have to find and attract new, lower-net-worth clients to increase volume. To safeguard against increased risk, the challenge will be to invent a new approach to customer selection adapted to this clientele.

Top-performing retail banks that once relied on *hook* or *stand-alone* strategies will have to rethink their approaches in favour of the *hybrid* strategy. Two key drivers will force this convergence of mortgage strategies. First, the increased importance of cross-selling will push banks to abandon the *stand-alone* strategy, as the decline in volume will force them to cross-sell more products. Second, heightened regulatory restrictions on some packages (such as mortgage plus lending insurance) will threaten those banks relying exclusively on *hook* strategies.

Retail banks will also have to rethink their business models and revert to their historic deposit-based approach, leaving behind the credit-based model they have relied on over the past few years. For several years, credit, and notably mortgage, drove retail bank growth.

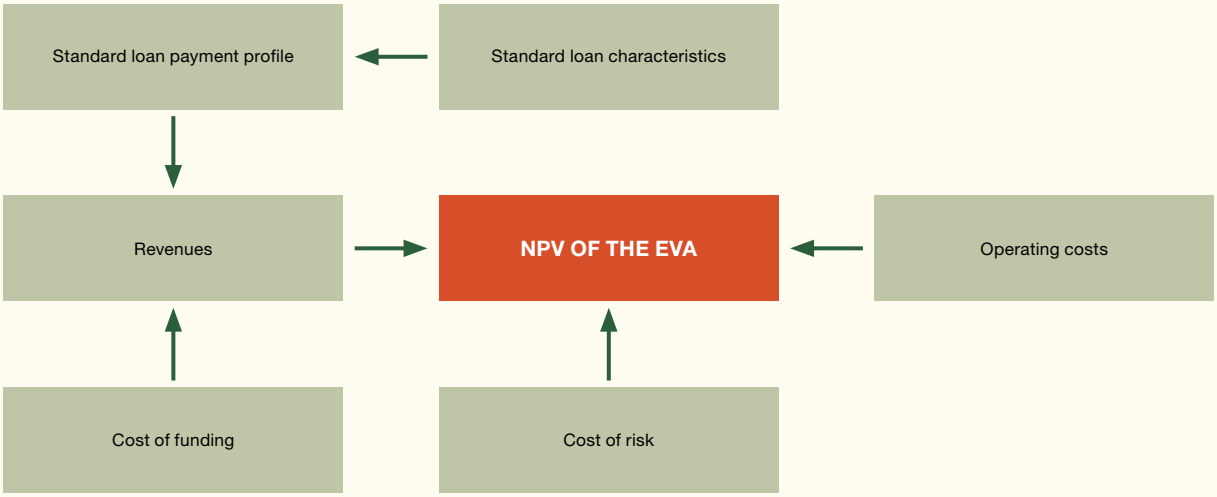
Today, the new market conditions are dramatically different: a declining economy, heightened funding requirements (Basel II constraints, limited access through securitisation), and the increasing cost of client risk are all jeopardising the old credit-based model. A new deposit-based approach appears to be inevitable. Successful banks of tomorrow will be those with the most deposits and therefore the highest capability to fund and transform those deposits into credits.

In this crisis context, mortgage specialists' ability to survive on their own is weak. With no access to deposits and no direct cross-selling opportunities, mortgage specialists will have to lean on diversified retail banks to get through the crisis. This would help mortgages become profitable again in the medium term, as the result of a lower supply.

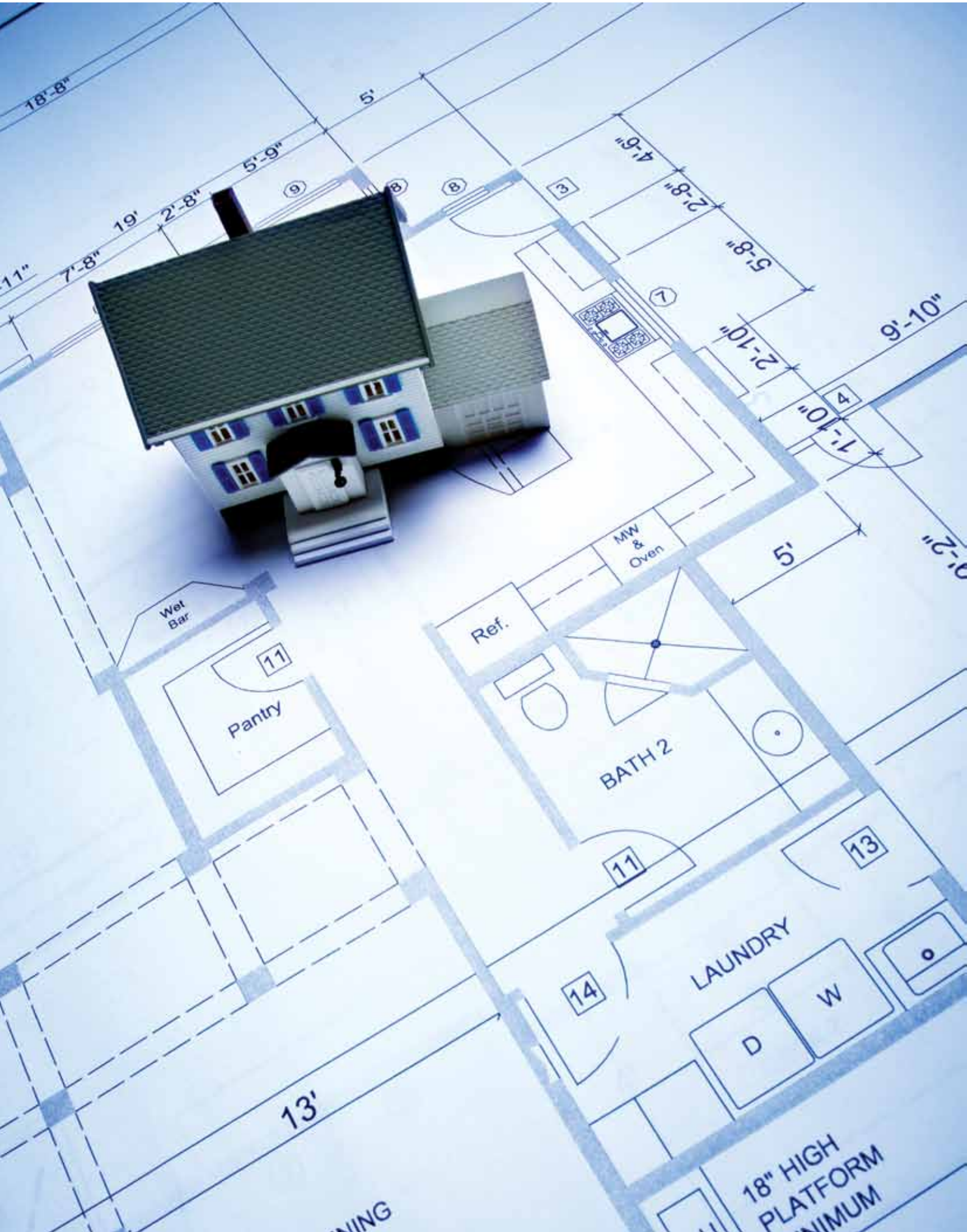
Over 80% of the banks reported they concentrate their profitability analyses exclusively on net interest margin, with some also taking into account other revenues (fees, insurance margins) in the mix. But only a few do what is needed to succeed today (see Figure 2.31): develop a complete vision of mortgage profitability, including revenues, cost of risk, operating costs (distribution, origination, servicing, and IT), and costs of capital employed; and use the key profitability indicators: net operating profit after tax, economic value added, and return on assets.

Managing mortgage profitability by developing excellent profitability models is the clear way forward, although today it is an under-used practice. We believe it is the best way for retail banks to ensure they are prepared for the daunting challenges they will face in the years ahead.

FIGURE 2.31 **Framework of *World Retail Banking Report 2009* Mortgage Profitability Model**



Source: Capgemini analysis, 2009.


18'-8"
5'
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7'-8"
4'-6"
2'-8"
5'-8"
9'-10"
2'-10"
1'-10"
MW & Oven
5'
Wet Bar
Ref.
Pantry
BATH 2
LAUNDRY
D
W
13'
18" HIGH PLATFORM

APPENDIX | Methodology

METHODOLOGY

For this sixth annual edition of the *World Retail Banking Report*, we have continued to refine the methodology used in previous editions. We have also expanded our coverage to include one new country, Russia.

Each of the 26 country teams contributed to its own national dashboard (see www.wrbr09.com), assisted in the pricing analysis, and conducted spotlight interviews. The dashboards on the website provide overviews of the national banking industry for each country surveyed. In every country studied, a national team identified the major macroeconomic indicators and described the retail banking environment, the type and size of players, the products sold, and the main trends in that country's retail banking industry.

The dashboards map these insights in a detailed and consistent format (see Figure A.1). This work also helped us determine which banks to include in the pricing index. Figure A.2 provides a complete list of the banks surveyed.

The main principles of our pricing index methodology remain the same as for last year. The pricing analysis provides both local and global views based on prices and frequency of use. We calculated prices on the basis of usage patterns for three kinds of user: less active, active, and very active.

To determine those groups, we split the total customer community into three parts. The 20% with the lowest consumption of banking services were considered the *less active* users, the 20% consuming the most the *very active* users, and the remaining 60% the *active* users. Figure A.3 shows how local profiles vary by usage pattern. In countries where consumer behaviour is tracked, bankers were able to provide this data or refine previous patterns; in other countries, local frequencies were estimated by our local retail banking experts.

To compare Internet and branch prices more effectively, this year we created two new profiles based on the local active user: the *branch* active user, who uses only branches, and the *Internet* active user, who uses only Internet products when available.

All comparisons between our 2006, 2007, 2008, and 2009 editions were made on the basis of three factors:

- *A flat exchange rate:* To compare price evolutions from 2008 to 2009, without those figures being skewed by exchange rate effects, we recalculated last year's prices for those countries that use a currency other than euros based on exchange rates of 8 September 2008.
- *A same-country scope:* For the countries added over the years since 2006 (Croatia, India, Ireland, Japan, Romania, Russia, and Singapore), we assumed a flat price evolution between 2006 and their first year in the report.
- *One frequency pattern:* The price focus of the comparisons was ensured by recalculating last year's price indexes based on this year's frequencies of use (eliminating effects from pattern changes).

As a result, the recalculated price indexes differ from the ones published in previous years' reports. For instance, the 2008 local profile price index is now recalculated as €71.8, compared to €70 published in the 2008 analysis.

We have refined some definitions in our product list to reflect changes in the products each bank sells. Some changes are only marketing window-dressing, but others are more substantial. For instance, we now distinguish Internet and branch usage by splitting four products (internal wire transfers, external wire transfers, standing orders, and direct debits) into branch and Internet categories.

FIGURE A.1 **Sample Dashboard**

Source: Banks' annual reports; Banco de Portugal. For more information, please go to our website, www.wrbr09.com.

Legend: CGD—Caixa Geral de Depósitos; BCP—Banco Comercial Português; BES—Banco Espírito Santo; ST—Santander Totta; BPI—Banco Português de Investimento; CEMG—Caixa Económica Montepio Geral.

FIGURE A.2 **Pricing Index Survey Sample: 203 Retail Banks in 26 Countries**

Europe Eurozone

Austria	Belgium	France
Share of deposits 76%	Share of deposits 66%	Share of deposits 88%
BA-CA BAWAG P.S.K Erste Bank Raiffeisenbank Sparkassen sector Volksbanken sector	Dexia Fortis ING KBC	Banque Populaire BNP Paribas Caisse d'Épargne CCF HSBC CIC Crédit Lyonnais Crédit Mutuel La Banque Postale Société Générale

Germany	Ireland	Italy
Share of deposits 68%	Share of deposits 100%	Share of deposits 65%
Commerzbank Deutsche Bank Dresdner Bank HVB Mutual banks Postbank Saving banks	AIB Bank of Ireland National Irish Bank Permanent TSB Ulster Bank	BNL Credem Intesa San Paolo MPS UBI UniCredit

The Netherlands	Portugal	Spain
Share of deposits 91%	Share of deposits 84%	Share of deposits 86%
ABN AMRO Fortis ING Postbank Rabobank SNS Bank	BCP BES BPI CGD MG Totta	BBVA Bancaja Banco Sabadell Banesto Bankinter Caixa Cataluña Cajamadrid CAM Grupo Banco Popular IberCaja Grupo Santander ING Direct La Caixa Open Bank Unicaja Uno-e

Asia-Pacific

Australia	China	India
Share of deposits 65%	Share of deposits 69%	Share of deposits 47%
ANZ CBA NAB St. George WBC	ABC BC BOC CCB CMB ICBC Minsheng Shanghai Pudong Development Bank Shenzhen Development Bank	Bank of Baroda Bank of India Canara Bank Citibank N.A. HDFC Bank ICICI Bank Punjab National Bank Standard Chartered Bank State Bank of India

Japan	Singapore
Share of deposits 77%	Share of deposits 86%
Bank of Tokyo-Mitsubishi UFJ Bank of Yokohama Mizuho Bank Resona Bank Sumitomo Mitsui Banking Corporation Sumitomo Trust and Banking Corporation	DBS Bank Overseas Chinese Banking Corporation United Overseas Bank

Europe Non-Eurozone

Croatia	Czech Republic	Norway
Share of deposits 83%	Share of deposits 81%	Share of deposits 61%
Erste Bank Hypo Alpe Adria Bank OTP Banka Privredna Banka Zagreb Raiffeisenbank Société Générale—Splitska Banka Zagrebacka Banka	CSOB Ceska Sporitelna GE Money Bank KB UniCredit	DnB NOR Fokus Nordea Sparebank 1 Midt-Norge Sparebank 1 Nord-Norge Sparebank 1 SR-Bank

Poland	Romania	Russia
Share of deposits 83%	Share of deposits 86%	Share of deposits 61%
BGZ BPH BRE (MultiBank) BZ WBK Citibank ING Kredyt Bank Millenium PEKAO PKO BP Raiffeisenbank	Alpha Bank Banca Comerciala Romana—Erste Bank Banca Romanasca Banca Transilvania Bancpost BRD Groupe Société Générale CEC ING Bank Romania Raiffeisenbank UniCredit Tiriac Bank Volksbank	Alfa Bank Bank of Moscow BSGV Citibank Gazprombank OTP Bank Raiffeisenbank Rosbank Russian Agricultural Bank Sberbank UniCredit Bank Uralsib VTB 24

Slovakia	Sweden	Switzerland
Share of deposits 87%	Share of deposits 84%	Share of deposits 100%
Ceskoslovenska Obchodna Banka Dexia Slovenska Sporitelna Tatra Banka UniCredit Vseobecna Uverova Banka	Danske Bank Nordea SEB SkandiaBanken Svenska Handelsbanken Swedbank	Cantonal banks Cooperative banks CS Regional banks Other banks UBS

United Kingdom
Share of deposits 88%
Abbey Barclays HBOS HSBC Lloyds TSB RBOS

North America

Canada	USA
Share of deposits 93%	Share of deposits 35%
BMO CIBC Desjardins RBC Scotia TD	ABN AMRO Bank of America—Fleet Boston Citigroup HSBC J.P. Morgan Chase Sun Trust U.S. Bancorp Wachovia Wells Fargo

Source: Capgemini analysis, 2009.

FIGURE A.3 **Examples: Local Profile Variations by User Type**

		Australia			Sweden		
		Less Active	Active	Very Active	Less Active	Active	Very Active
Account Management	For one year						
Online banking	# of connections	0	12	24	0	23	59
Payments							
Cheque	# of cheques	0.5	1	2	0	0	0
Internet internal wire transfers	# of transfers	8	12	24	4	10	15

Source: Capgemini analysis, 2009.

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Creval
Deutsche Kreditbank
Dexia
Erste Bank
Fortis[a]
Groupe Banque Populaire
HSBC
HVB
Hypo Alpe Adria Bank
ING[a]
KBC
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LCL
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Nordea
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SBAB
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SNS
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Sumitomo Trust Banking Corporation
Swedbank
UBS
UniCredit[a]
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[a] Interviews in two or more countries per bank.

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