strategy&

The future of banking through a Kiwi lens

pwc

Foreword

The history of banking stretches back some 14,000 years, though we're perhaps seeing some of the most significant developments in the sector right now. Driven by influences in changing consumer tastes and, of course, the constant development of technology, there has rarely been a time of more disruption and competition – risk and opportunity.

The attached PwC Strategy& Future of Banking in Australia report looks at the performance of the big four banking institutions, as well as some other major players in the industry, and brings to the table some important questions. Considering the penetration of Australian-owned banks here in New Zealand, and the relationship we have with our Trans-Tasman neighbours in the banking sector, any difficulties or successes in the Australian market are sure to impact those on our side of the ditch.

When we look at the report, we see the six most impactful trends hitting the financial sector. All of these can be looked at through a New Zealand lens – they have to be, if our banks are to stay relevant, profitable and evolving to suit the environment.

Each of these six forces also brings questions that are difficult to answer, but ones that CEOs simply have to face.

1) Changing demographics

Let's first take changing demographics. The Future of Banking report points out that banks are increasingly having to pivot their service offerings as the customer demographic morphs from the wealthiest generation in history to the most indebted. In New Zealand, half of our population have some form of debt, with 35- to 44-year-olds the most indebted age group[1], which brings up questions about how our banks service different, less-wealthy demographics and whether their appetite for risk is changing as a result.

This also poses some big questions for CEOs in the sector: Are NZ banks ready for a wider change in their banking models because of a change in their customers' circumstances?

2) Changing technology

Next in the report is the impact brought about by the constantly changing technology environment, which "could empower competitors to improve consumer relationships, potentially relegating banks to being wholesale providers of balance sheets and other undifferentiated services", the Australian study reads. Our exposure is certainly no less in New Zealand.

Many may find they aren't ready. In fact, 70% of NZ CEOs in financial services are concerned with the pace of technological change[2]. To make the issue more urgent, 80% of consumer banking could be disrupted between now and the end of the decade[3] by FinTechs and other forces.

So, how do emerging technologies open up opportunities for banks to reinvent themselves that haven't existed before?

3) Changing consumer behaviour

At the same time, changing consumer behaviour is forcing banks to re-evaluate their products, services, operations and communications – and technology is facilitating. However, looking at the biggest business challenge among CEOs, 75% still said it is meeting developing customer needs with new offerings[3].

Today's customers are always online and work with better resources than they had a decade ago, which makes them confident in finding the best offer at the best price and via the best service.

New Zealand banks will need to provide what consumers want with more intimate, immediate communications and a seamless digital experience – because FinTechs are increasingly using these techniques to get closer to their audiences.

Incumbents are trying to build these bridges in various ways, but in New Zealand, it's interesting to see that 80% of banking CEOs see customer relationship management as the technology that will bring the greatest return on investment[2]. This trend is on their radars.

Yet the question remains: This isn't the last time consumer behaviour will change, so how quickly can banks respond to keep up with them, both now and in the future?

4) Asiafication

Casting our eyes slightly away from our shores, Asia is becoming ever more relevant to the Australian and New Zealand markets, not only economically but also socially and culturally.

Asiafication is bringing new market entrants into the banking world who can accommodate the particular needs of businesses and families from the continent. With New Zealand's close ties to Asia, from both an immigration and commercial perspective, what happens on the world's biggest continent will continue to influence banking performance on our shores.

If new banks are establishing themselves to serve this market, incumbent banking organisations may be asking themselves: are they meeting the imported expectations from Asian consumers?

5) Interventionist government

Next there is the ongoing impact of an interventionist government. Government and the banking sector will always be closely aligned, and regulations are only going to get more stringent looking ahead. On both sides of the Tasman, how the Government and regulators balances compliance requirements with the ease of doing business will be a pressing issue.

From a New Zealand perspective, the top barrier to growth named by Kiwi financial services leaders is over-regulation (86%), while the Government's response to fiscal deficit and debt burden (72%) was a close second[2].

How can banks find faster, better ways to manage compliance? In the near future, this is the type of question New Zealand's incumbents will continually ask themselves.

6) Subdued macro economy

Lastly we have the challenges of a subdued macro economy, which New Zealand banks are no stranger to. In essence, we face an uncertain outlook in terms of funding costs, the cost of credit and how banks operate as part of the global economy.

Today, only 23% of NZ CEOs see an improvement in global growth, compared to a more optimistic 47% in 2015[2].

Will the New Zealand Government put the same emphasis on innovation as the Australian regulators have? Moreover, how do banks protect what they have while preparing for the changes that may occur in key local markets – ensuring they are growing where growth is occurring?

We hope you find the Future of Banking report useful as we continue to look for potential roadblocks and opportunities in New Zealand's banking sector. The need to change is more urgent in today's commercial world; but fortunately, the ability to change has also never been better.

Priorities for 2020

In terms of proposed responses by Australia and New Zealand banks, the report outlines six priorities for firms to think about as we approach the end of the decade:

- Explicitly organise around the customer: Don't just market customer-centricity, live it.
- Simplify: For the good of customers and staff.
- Optimise footprint throughout the value chain: Streamline to strategic essentials and take partnerships to the next level.
- Focus of specific areas of innovation: Even 100-year-old institutions can still adapt.
- Proactively embrace regulation: AAA-ratings are the most valuable off-balance-sheet asset NZ and Australian banks have, so we must rethink our relationships with regulators.
- Put your culture to work: Not just having cultural aspirations, but delivering on them.

Lastly, we value your input on what you consider to be the immediate outlook for New Zealand banks, as well as how influential forces from the Australian sector – and the global economy – will affect our future.

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[1] "Half of Kiwis In Debt, With Most Debt In Properties". Stats.govt.nz. 2016.
[2] 19th Annual CEO Survey. PwC, 2016
[3] Global FinTech Report. PwC, 2016

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Executive summary

Simpler, smaller and more deeply connected to customers

The Australian banking sector is in a state of flux. Renewed debate about culture and reputation, as well as uncertainty around the pace, scale and breadth of strategic disruption to the industry, mean that the bank of the future will look very different to the bank of today. Bankers, regulators, directors and investors would do well to ask:

- *What is the state of Australian banking today, and how is it changing?*
- *How should the industry respond to these changes, and what will it look like in the future?*
- *What can individual banks do today to win in the new environment?*

Six powerful forces are shaping the banking industry in Australia today: changing demographics, technology, consumer behaviour, Asia, government and a subdued global economy. These forces are driving change at precisely the time when traditional value drivers for the industry – asset growth and, to a lesser extent, leverage – are dissipating, and may even reverse. As a result, return expectations and the future outlook for the industry are being revised down with almost every earnings announcement.

To continue creating economic profit for shareholders, banks need to become *simpler* and *smaller,* but *more deeply connected to customers* than they have been in the past. How? We propose six fundamental priorities for banks in the years ahead:

1. Explicitly organise around the customer.

2. Simplify the offer, face and voice.

3. Optimise the footprint throughout the value chain.

4. Focus on specific areas of innovation.

5. Proactively embrace regulation.

6. Put culture to work.

The winners – those who can successfully navigate this landscape – will also be more valuable than they are today. They will have more diverse sources of income and more sustainable economic profit. But this will not apply to everyone, and possibly not even to the industry as a whole.

For perhaps just the third time in three decades, the industry is poised for fundamental realignment. Managing this transition, and the timing of necessary changes, will be crucial to success in the years ahead.

Powerful forces reshaping the banking industry

A number of trends are driving long-term change in Australian banking. While they are all broadly understood, banks are also at very different stages of maturity in terms of grappling with their implications.

1. **Changing demographics**. The population is becoming older, increasingly urbanised, richer and more diverse, while also becoming more interconnected across national boundaries. There is less of a distinction between 'wealth' and 'banking' products and advice in the eyes of customers, and marketing and service propositions have to be targeted to increasingly narrow (though potentially global) customer segments. In addition, as the wealthiest generation in Australian history transfers assets to the most indebted one, banks need to be able to quickly pivot their service proposition to reflect dramatically changing financial circumstances for specific customers.

2. **Changing technology.** Information systems are becoming more open, modular and capable. For banks, this increases both the scale and speed with which they can leverage data, analytics and communications to create richer, more targeted value propositions for specific microsegments or even individuals. Unfortunately, the same applies for current and potential competitors. Many will be better placed to take advantage of the most lucrative new opportunities and to insert themselves into the relationship between banks and their customers, potentially relegating banks to being wholesale providers of balance sheet and other undifferentiated services.

3. **Changing consumer behaviour.** Consumers are better educated, more law abiding, tolerant, confident, trusting – as well as better informed, aware and ready to reassess and retract that trust. As they do more of their business online, communicating with friends and peers over multiple social media channels, they are increasingly confident in being able to identify the best offer, at the best price, from anywhere in the world. That's the lesson Australian retailers – long accustomed to the 'tyranny of distance' and being able to charge 'the Australia tax' – learnt when they saw how quickly consumers

switched to get a better deal. For banks worried that they too may be approaching their own tipping point, this is a threat. But it is also an opportunity to elevate the intimacy of historical customer relationships.

4. **'Asiafication'.** Asia is becoming ever more relevant to Australia, not only economically but also socially and culturally. The domestic economy is linked to the fortunes of Asian economies, and of China in particular, not just in terms of exports but also foreign-direct investment, business partnerships, domestic services and of course residential real estate. Familiarity with Asian (including subcontinental) languages, currencies, culture, norms and national idiosyncrasies is no longer imperative just for trade finance teams or branches in specific suburbs, but is increasingly a professional requirement for an Australian banker.

5. **Interventionist governments.** Twenty years after Bill Clinton proclaimed '*The era of Big Government is over*', it is clear that the era of deregulation is over. Governments, along with their regulators and central banks, are reasserting authority over the macro economy in general and the banking industry in particular. For banks, government relationship management is moving, if it hasn't already, from the domain of corporate affairs to the top of the C-suite agenda.

6. **Subdued macro economy.** The next 3–5 years will be characterised by slowing productivity growth, environmental constraints, debt, de-leveraging, financial repression and an ongoing sense of uncertainty. As events around the world demonstrate, economic uncertainty feeds into and is further amplified by political uncertainty, exacerbating the risk. What growth we do see is increasingly driven by small and micro businesses, especially in the service and freelance economy, which business banks, traditionally oriented to asset-backed lending, struggle to properly serve.

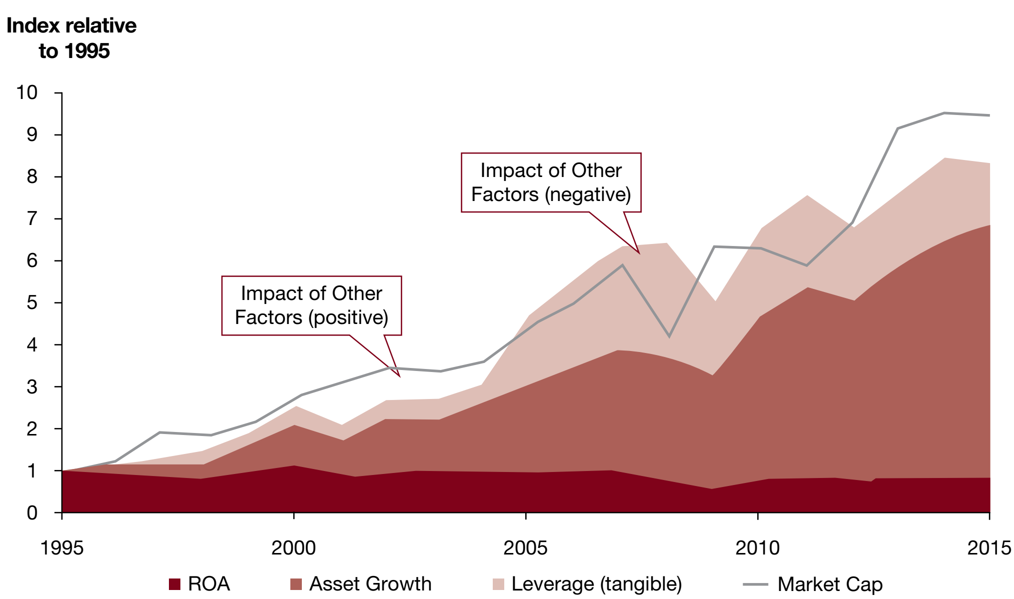
Even in the presence of these forces, it's worth remembering that some things are not changing. Whatever happens in the future, it seems certain that owning a home will still be 'the Australian dream'. Australians will still need guidance making complex decisions about spending, saving, investment and insurance. Businesses will still be complex to run, and will require help with investment, funding, risk management and other challenges. As a nation, Australia will continue to run a substantial balance of payments deficit which, if not funded by wholesale bank debt, will have to be funded some other way. Finally, notwithstanding excitement about P2P and other FinTech innovations, there will still be a need for financial intermediation, as well as the maturity, liquidity and credit transformations that so far only traditional banks can provide at scale.

Past engines of value creation are abating

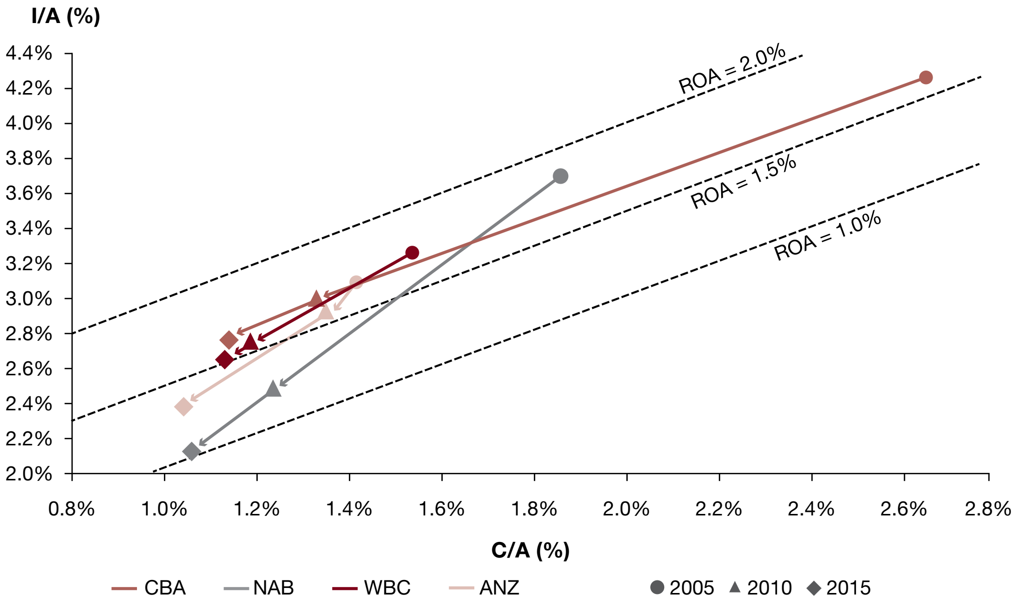
All of this is happening at a critical time for Australian banks. As illustrated in Figure 1, for the past 20 years Australia's major banks have managed to create enormous value for shareholders off the back of asset growth and increased leverage, with the former driven since the GFC almost entirely by residential lending. These two factors have ameliorated the fact that over this same period, return on assets (RoAs) have remained flat or been in decline as cost efficiencies have been passed on to customers through lower income margins. This is illustrated in Figure 1. While portfolio mix accounts for some of this shift, overall the data demonstrate both the success banks have had in leveraging technology and globalisation to lower their costs, and the success of consumers in capturing the benefits of those savings. This is to be expected in a market characterised by competitive suppliers providing undifferentiated products (what we would call a *commodity trap*) rather than the highly individualised services that banks see themselves providing, or the comfortable oligopoly some of the industry's detractors believe they see.

Figure 1: Rising tide lifts all boats: deconstruction of bank value creation since 1995 (Big 4)

Superlative asset growth ...



… ameliorating ‘commodity’ like industry dynamics



Note: NAB figures have been adjusted to exclude UK earnings and assets

Unfortunately, those drivers of value creation are likely to abate – or even reverse – over the next few years, due largely to the six forces mentioned above. For example, whatever happens with the Australian housing market, it is highly unlikely that major bank mortgage books could triple over the next decade as they have done over the previous one, or that regulators would allow it even they could. Capital and liquidity are also constraints on growth.

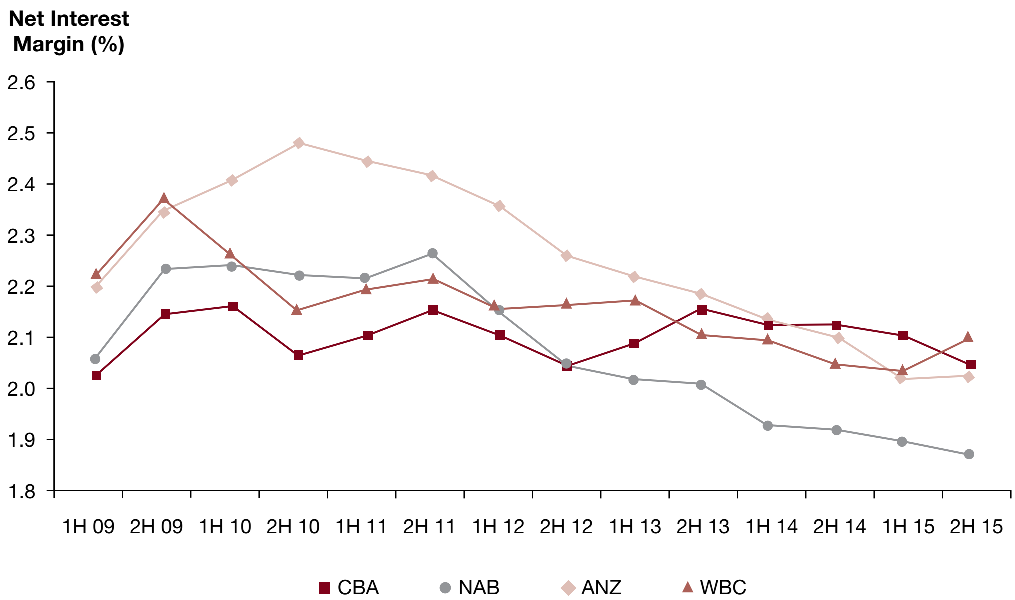
What’s more, new technologies and changing customer preferences mean that the share of the Australian banking ‘pie’ – no longer growing as it has in the past – is also becoming more contested. Other trends are no more encouraging. Interest margins have been steadily shrinking and non-interest income has remained broadly flat (Figure 2), while asset quality, capital and the cost of such things as technology and regulatory compliance are all moving in the wrong direction – conditions the industry hasn’t seen in a very long time. As margins shrink and transparency increases, the ability of banks to cross-subsidise products and services across relationships diminishes, putting further strain on longstanding operating models.

In response, return aspirations for the majors have retreated from the high to the low teens faster than anyone expected, and no one knows how much further this process still has to run (noting that single-digit returns have long been the norm almost everywhere else in the developed world). Share prices, which have retreated almost 20 per cent over the past 12 months, reflect this.

Figure 2: Banking industry's deteriorating economics (e.g. Big 4)

Shrinking NIMs …

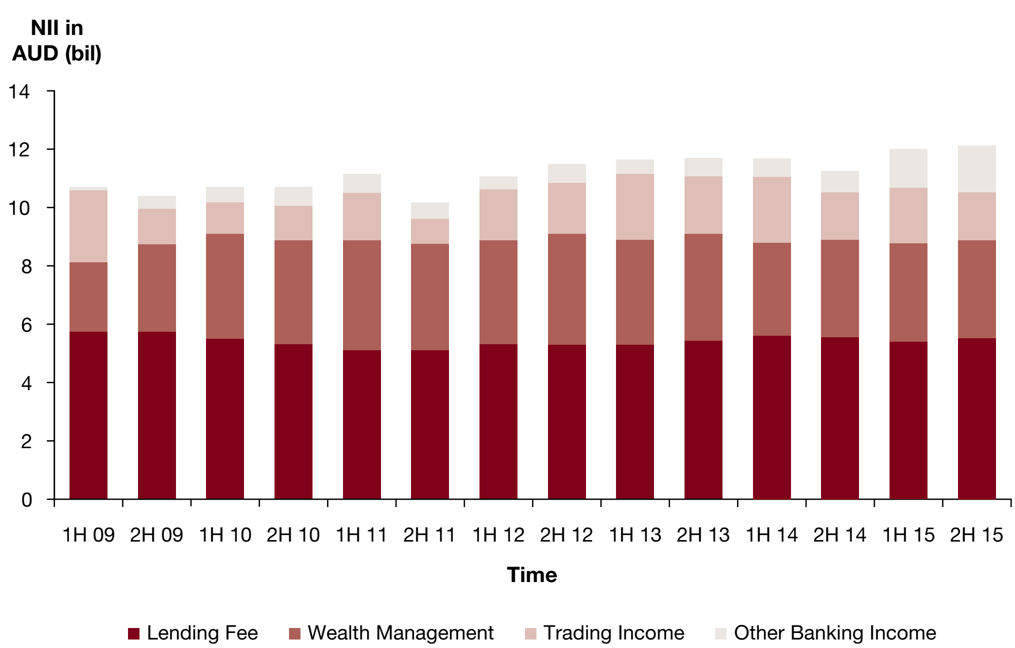
Net Interest Margin for Big 4 Australia banks
(NIM in %, FYH109-FY2H15)



Source: Bloomberg, Company annual reports, PwC analysis

… and flat NII

Non Interest Income for Big 4 Australia banks by Business Lines
(NII in AUD Billion, FYH109-FY2H15)

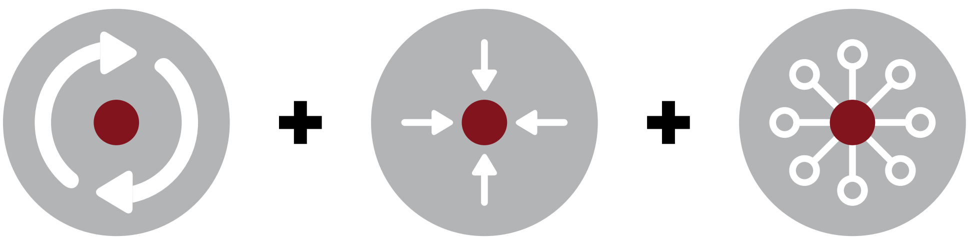


If Australian banks are to continue creating economic profit for shareholders, they will have to do two things. They will have to continue and possibly even accelerate their efficiency agenda. Given changes in technology and the other forces mentioned above, the efficiency opportunity for banks in the next decade is likely more significant than it has been over the past two. But they will have to do more than that. To ensure that the value of efficiency savings is shared with all stakeholders, including shareholders, banks will need to get better at delivering differentiated offers to specifically targeted customers, rather than all competing to provide the same services to the same people.

In short, they will have to escape the commodity trap.

Banks must become simpler and smaller, but more deeply connected

To do this, banks must become *simpler* and *smaller,* but *more deeply connected* to customers.



Simpler – but more accessible and relevant

Simpler banks will have the courage to undertake a radical rationalisation of their product and service suite, even if this comes at the cost of short-term revenues. They will be prepared to streamline their corporate messaging to focus on a few key, meaningful points of view that resonate with clearly targeted market segments, even if this means appealing to a narrower set of customers. They will embrace a holistic, multi-dimensional approach to social media that engages staff, customers and business partners to convey a clear and focused vision of who they are and what they do. They will also make disciplined choices about who their customer value proposition serves best, and who it doesn't. They will stop trying to be equally relevant for everyone (while still fulfilling society's 'universal' service expectations). They will concentrate their proposition on the segments they feel they have a right to win, and allocate financial capital, physical capital, people and reputational capital to those areas.

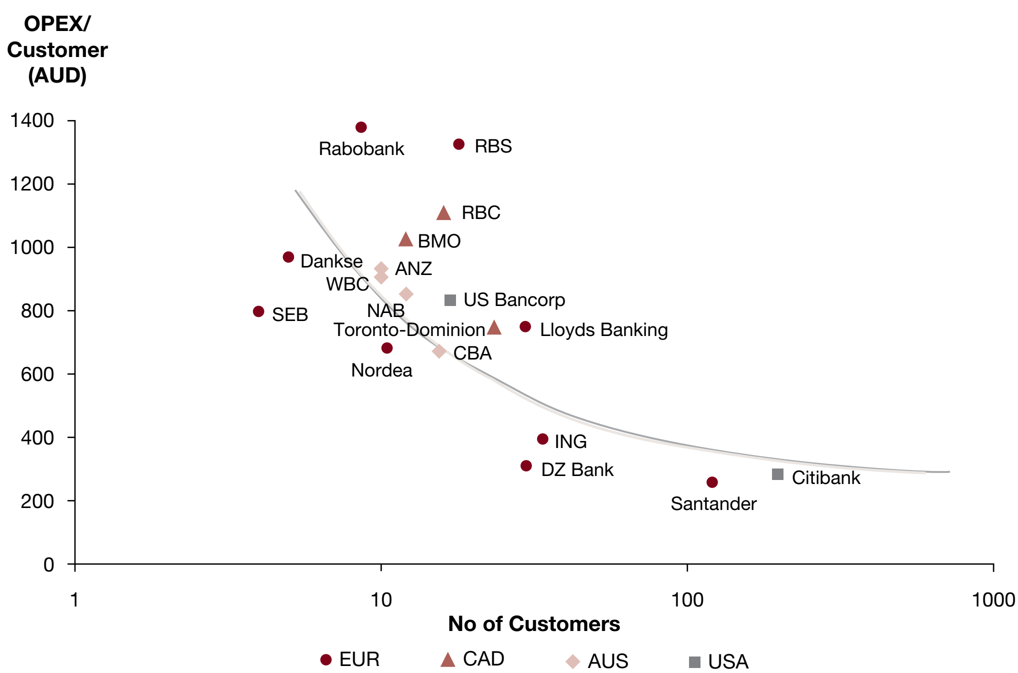
In short, they will make hard choices. To be fair, many have been making hard choices for years. Since the GFC, Australia's banks have managed to keep their overall cost base flat even as assets and customer numbers have grown. They have achieved this through investment in efficiency and increased scrutiny of non-value-adding activities and costs. This is indeed an accomplishment. But as bankers recently arrived from Europe or the US know, since the GFC, they have been playing a different game over there.

Figure 3 illustrates this point well. Adjusted for scale, Australian banks have always been efficient on a global basis, though by no means best-in-class. However, when looking at what US and European banks have done since the GFC, the Australian banking system's productivity trajectory looks less favourable. These benchmarks might not be directly comparable, as each bank has a different business mix and operates in a different market. However, the overall message is clear, and is supported by substantial anecdotal evidence.

Figure 3: Australian banks may have room to ramp-up their efficiency agenda

While Australian banks are generally efficient …

Operating Expenses Per Customer vs Log Number of Customers for Australian banks vs European, US and Canadian banks
(OPEX Per Customer in AUD, Log Number of Customers, FY15)

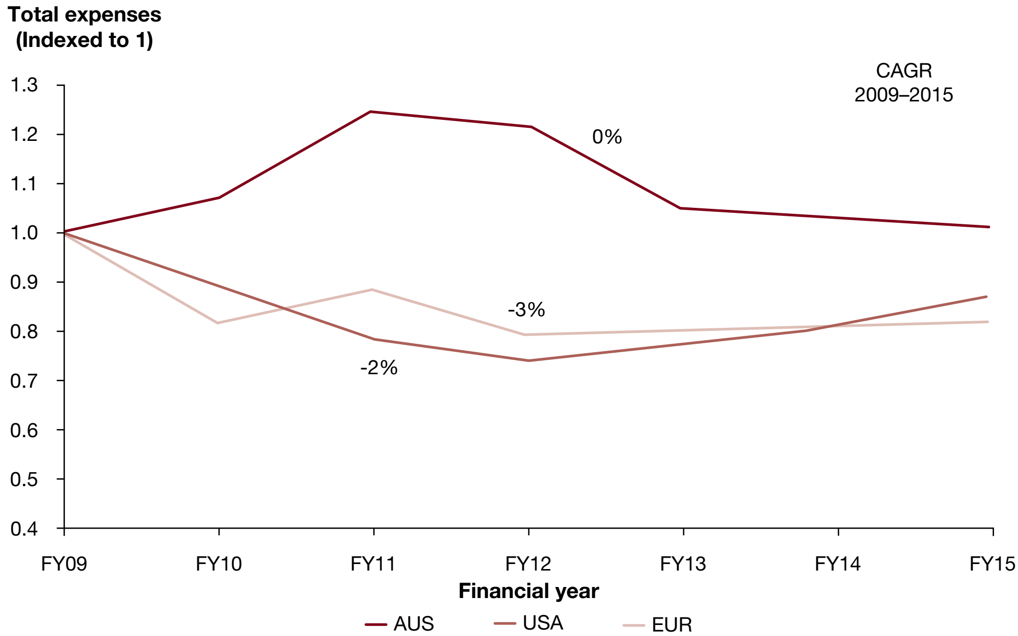


Note: Opex is calculated as total operating expenses excluding loan/credit losses and impairment charges. All cost in foreign currencies were converted using FX rate dated 1 July 2015

Source: Company websites, Company annual reports, www.oanda.com

… they have not cut costs as aggressively as others

Average total expenses – Major Australian banks against US and EUR banks
2009 – 2015 (Indexed to 2009) AUD Million



Note: Expenses calculated by subtracting Profit before tax from total non-interest and interest income. European banks are BNP Paribas, Santander, BBVA, SEB and Mbank, US banks are Wells Fargo, JPM, Citibank and BOA

Source: Bloomberg, Company websites, Company annual reports

Smaller – but more focused and better differentiated

The bank of the future is also likely to be smaller. They may not have fewer customers, but they will have a clearer and narrower view of who their natural customers are. They will make more radical 'make or buy' decisions anchored around a coherent system of core capabilities, leveraging third parties for everything else. They will be more focused and strategic in how they select, share information and work with business partners, from traditional ones like brokers and independent financial advisers to software companies, professional services firms and other service providers.

California-based East West Bank has built a successful franchise focused on serving America's Chinese community and facilitating US–China trade flows. Its total asset base is just US$30bn, yet it is worth more than US$5bn and, despite its small scale and the competitive nature of the US market, enjoys an earnings multiple 50 per cent higher, and balance sheet productivity 100 per cent higher, than Australia's Big 4. Its ROE is higher than Wells', the most valuable bank in the world.

Also in the US, USAA is known for its dedication to customer service. Their Net Promoter Score® is not only the highest of any bank in the world, it is higher than Apple's. This achievement is due in part to their narrow focus. They have no business bank, no private bank, and are selective about which of their own products they manufacture. Their purpose is to provide members of the US military and their families with first-rate personal banking services, and they have nurtured a reputation for customer focus, innovation and growth.

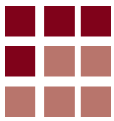
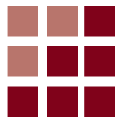
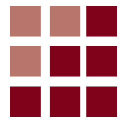
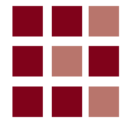
One of the best illustrations of the value of simplicity and focus comes not from banking however, but investment. For almost half a century Vanguard has stood for one thing: the value of low-cost, index-based, passive investing. The entire company, including their marketing, messaging, corporate sponsorships and even interviews with executives all centre on the almost evangelical promotion of this point of view. It is not for everyone, but they make it easy for customers to decide if it is for them. Many do. With almost $3.5T in FUM, Vanguard attracts more than half of all net inflows in the US market, which is an example of how focusing on a 'smaller' market sub-segment can create a franchise that is anything but small.

More deeply connected – to solve problems that haven't been solved before

Banks that are genuinely connected to customers can leverage technology and partner relationships to solve problems banks traditionally haven't solved – problems such as tax, inventory, supply and invoice management. It might include supporting decisions such as choosing a place to live, healthcare and even schools for the children. Consider the customer-facing front end of a bank's IT architecture, as illustrated in Figure 4. Rather than just a set of online properties and internet banking applications, this can be curated into bundles of diverse digital solutions, with each bundle aligned to the needs of specific segments. Some might be purpose-built by the bank, others provided by partners, perhaps on a variable-cost (*software as a service*, or 'SaaS') basis, and always hosted in the cloud. The important thing is that they solve problems banks traditionally never solved, and work together to make the bundle unique, targeted and irreplaceable.

If they are done well, new services like these can provide additional revenue and profit pools to compensate for diminishing returns in traditional lines of business. But they can do more than that. By more closely tying customers in to their banking relationships, they can help banks escape the commodity trap, and so defend those traditional returns as well.

Figure 4: Curated propositions targeted to specific customer segments

Self-employed (blue collar)	Self-employed (professional)	Hospitality	Retail
			
Tax solutions (BAS) Working capital Personal injury protection Milestone-based invoicing Incurred-expense accounting Investment solutions (simple)	Tax solutions (BAS) Personal liability protection Time and materials-based invoicing Investment solutions (complex)	Tax solutions (BAS) Payroll solutions Commercial property finance Capital finance Business P&C protection	Tax solutions (BAS) Payroll solutions Working capital & trade finance International logistics/shipper solutions Commercial property finance Business P&C protection

Insourced/customised   Outsourced/acquired

All this is easier said than done, as it will require rethinking longstanding norms and practices in areas from IT architecture, procurement, data, product strategy, security, privacy and the very capabilities and competencies expected of a 'banker'. These days it's hard to find a bank executive or director not already animated by the prospect of becoming the *orchestrator* and *curator* of integrated solutions for customers. However, the industry is just beginning to grasp the full implications of this vision, and no bank we know in Australia has a fully-formed view of how they want this to play out.

Privately, many bankers express alarm at the prospect of letting someone between them and their customers in this way, seeing it as leading to erosion of advantage and an undermining of their franchise. Unfortunately, in a world of increasingly sophisticated, diverse and demanding customers, no single company is able provide the complete suite of services necessary to satisfy all of their needs.

Other executives take a different view – wondering whether there isn't a strategic play in retreating up the value chain and focusing on becoming a highly-efficient, scale-intensive balance sheet utility serving the rest of the industry, leaving other players to compete for increasingly targeted and specialised services to ever-smaller customer segments.

Unfortunately, the market for wholesale funding is already well-supplied, so the profit would have to come from other, as-yet unspecified services. In Australia, unlike in some other markets, such a balance-sheet player would enjoy none of the opportunities for market or regulatory arbitrage that have characterised many profitable wholesale funding propositions in the past.

In short, there are no easy options. Becoming *more deeply connected to customers* as described in this survey will not be easy. It will require banks to expand the scope of solutions offered while shrinking (or at least not growing) their balance sheet and operations. It risks dissipating strategic focus by getting involved in activities where they have limited history or natural advantage. And it almost surely requires that banks allow other players into the circle of their customer relationships, with no certainty as to how that will work out. But the opportunities for those that get it right are significant. Many customer-centred, segment-focused banks, including USAA, mBank, Signature, First Republic and BankMobile, as well as universal behemoths like BBVA and Santander, are showing that this can be done.

Six fundamental priorities for change to 2020

What can an individual bank do to succeed in this environment? In addition to pursuing the usual business imperatives (risk, balance sheet, capital, pricing, talent, etc.) we propose six fundamental priorities for banks in the years ahead.

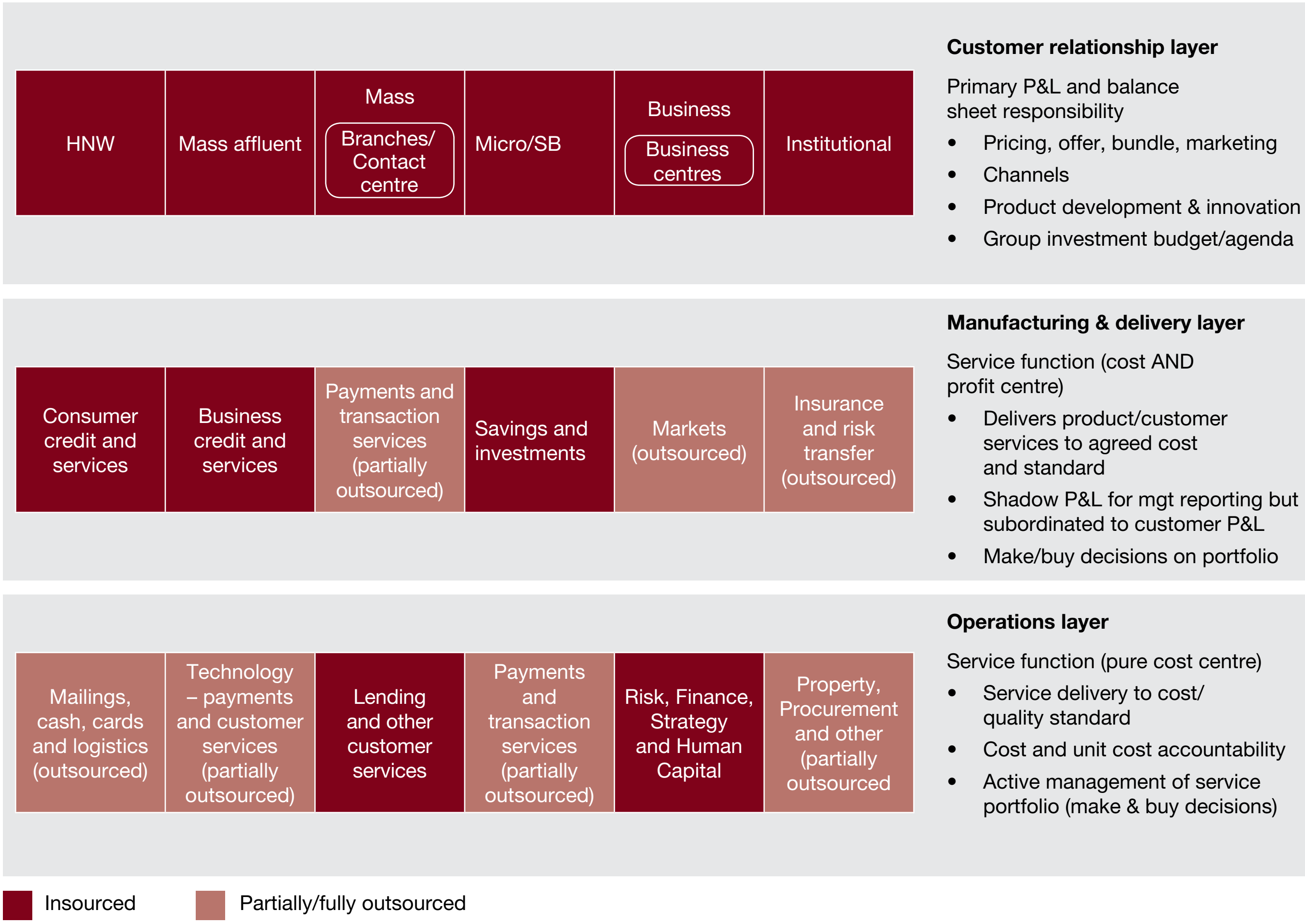
Explicitly organise around the customer

'Customer-centricity' is hardly new, and banks have always recognised that if they are to avoid competing on margin and price, then they need to distinguish themselves on service. Banks are also doing many of the right things, from detailed tracking of satisfaction metrics, spending time with focus groups, investing in market research, data, and analytics and inviting customers to spend time with executives and even the board. Banks are also working hard to incorporate lessons from other industries by seriously studying the practices of the world's great service companies such as Disney, Four Seasons, Zappos and Nordstrom.

But these are all steps in the journey. Customer-centricity needs to be visible not just on the lanyard or cover of the annual report. It should be visible on the organisational chart, in the financial reports, the IT architecture, the product catalogue and management accounts. Most importantly, it should be visible in the formal and informal norms about who has decision rights (i.e. power), how those decision rights are executed when hard choices need to be made, and how those decision makers are measured and rewarded.

Whatever the mission statement says about customers, if the most powerful decision makers in an organisation are aligned to products, geographies or functions; and measured, rewarded and promoted based on the performance of those things; then when crucial trade-offs are to be made, the choices of the organisation will reflect that, and customers will notice.

Figure 5: Streamlined, customer-centred organisation



Consider the organisation and operating model illustrated in Figure 5. It shows clearly defined, executive committee-level executives aligned to specific customer segments employing holistic P&L measures, and organisational authority invested in them, including control over pricing, offer, investment and the direction of the product development and innovation agenda. They are accountable as the internal authority on the needs, preferences and behaviours of the customers in their segment, and to invest in the data and analytics capabilities necessary to be that. And their people know what to do to deliver a great customer experience because they understand what's important for their customers, and how their customers differ from those in other segments.

To our knowledge there is no bank anywhere in the world organised in this way, or even in a position to be so without substantial restructuring of its information and reporting systems, and much else besides. But banks have certainly been moving in this direction, including in Australia. Other banks, for example USAA in the US, retain a traditional organisation structure at the top level (which is almost imperative for multi-jurisdictional banks) but below that organise teams around segments, and then go further by organising around life events such as graduation or divorce. As a result, customers who may not have given much thought to their bank for many years, suddenly in a moment of truth when speaking to someone in the contact centre, experience USAA as being empathetic, helpful and smart.

Simplify the offer, face and voice

When an organisation becomes truly aligned to the customers it seeks to serve, it becomes easier to understand what resonates with them. Yet despite years of improvement, customers remain more confused and sceptical of their banks' *offer* than they need to be. It still comprises too many variations on a relatively small number of core services – variations which are often unclearly differentiated and poorly explained. Likewise, the different channels and points of contact banks present as their *face* to customers sometimes seem more like separate organisations to be navigated rather than options offering flexibility and choice. Finally, the *voice*, which spans marketing, corporate communications, fit-out of physical premises and especially social media, still caters to too many different messages and purposes.

Less confusing for customers

Every situation is unique, however less is usually more:

- fewer points of contact – branches, apps, digital properties – so long as they are more functional and better integrated
- fewer marketing messages – so long as they are more targeted, personal and consistent (including messages from crucial sources such as friends, business partners and social media)
- fewer products that are easier to understand and compare – with necessary differences between such things as loan terms, fixed or variable interest, etc. parameterised as customisable features rather than requiring different product choices.

Consider mortgages, which for Australia's major banks is a singularly important source of economic profit. A customer visiting the home lending page of some banks today is confronted with a range of products at very different price points (at time of writing, as much as 150 basis points from one bank), but with ambiguous product names and descriptions, and prices inconsistent with advertised features. For example, a recent review of bank marketing materials revealed:

- a 'discount' offer that was, due to special deals on some other products, one of the most expensive on the page

- a ‘no fee’ offer that was difficult to evaluate due to insufficient information about the fees on alternative products
- a fully-featured ‘package’ deal with a headline rate so attractive, reviewers asked whether there was a catch, and
- an ‘all in one’ product with a very high headline rate promoted with the tagline ‘*putting you in control*’, which begged the question what ‘control’ consumers were forsaking by choosing a more affordable option.

Is it any wonder customers get confused, lose confidence and then seek the advice of a mortgage broker – whose commissions absorb a substantial share of the economic profit on the deal?

Imagine a bank that offered just one mortgage product – called ‘Home Loan’. Imagine that it could be customised online, with the rate and associated fees adjusted on screen in real time. What if fees were simple – one monthly fee, ideally zero – rather than requiring a close read of the product disclosure statement to understand? How many more customers would have the confidence to make their own choices – contacting the bank only to close the deal, or even completing the entire application online? What does all this do to a bank’s distribution costs and product margins?

Less confusing for staff

And what does it do to staff engagement, service and cross-sell? The less bankers struggle to explain unnecessary complexity in the product portfolio, the more space there is for better conversations and advice. This is one of the most straightforward ways to increase banker productivity and customer satisfaction. The same is true of operations, IT and compliance, which expend disproportionate investment and effort dealing with product complexity and special features. How much easier would it be for employees to be ‘customer-focused’ once untangled from all this?

One bank in another market found that after a minor rationalisation of its core banking product and the introduction of a no-frills, low-cost ‘vanilla’ retirement offer (comparable to what would be called ‘simple super’ in Australia), cross-sell of wealth product through bank branches rose substantially – with no other substantive changes to banker training, incentives or communications. Another bank in the UK had a similar experience with a much more radical pruning of its product set (almost 70 per cent by product count), as did a recent client in the US.

Optimise footprint throughout the value chain

One consequence of a simpler ‘face’ will be a smaller and more streamlined operational footprint through better integration with partners across the extended value chain.

Streamlining to strategic essentials

Almost every bank in Australia manages its own fulfilment, routine service operations and core banking systems, but very few consider any of these areas to be points of strategic differentiation. By contrast, for credit cards, many banks around the world are already comfortable leveraging the capability and scale of a small number of global card processors and issuers who provide high-quality, low-cost ‘utility’ service. That is a model that can work in many other domains.

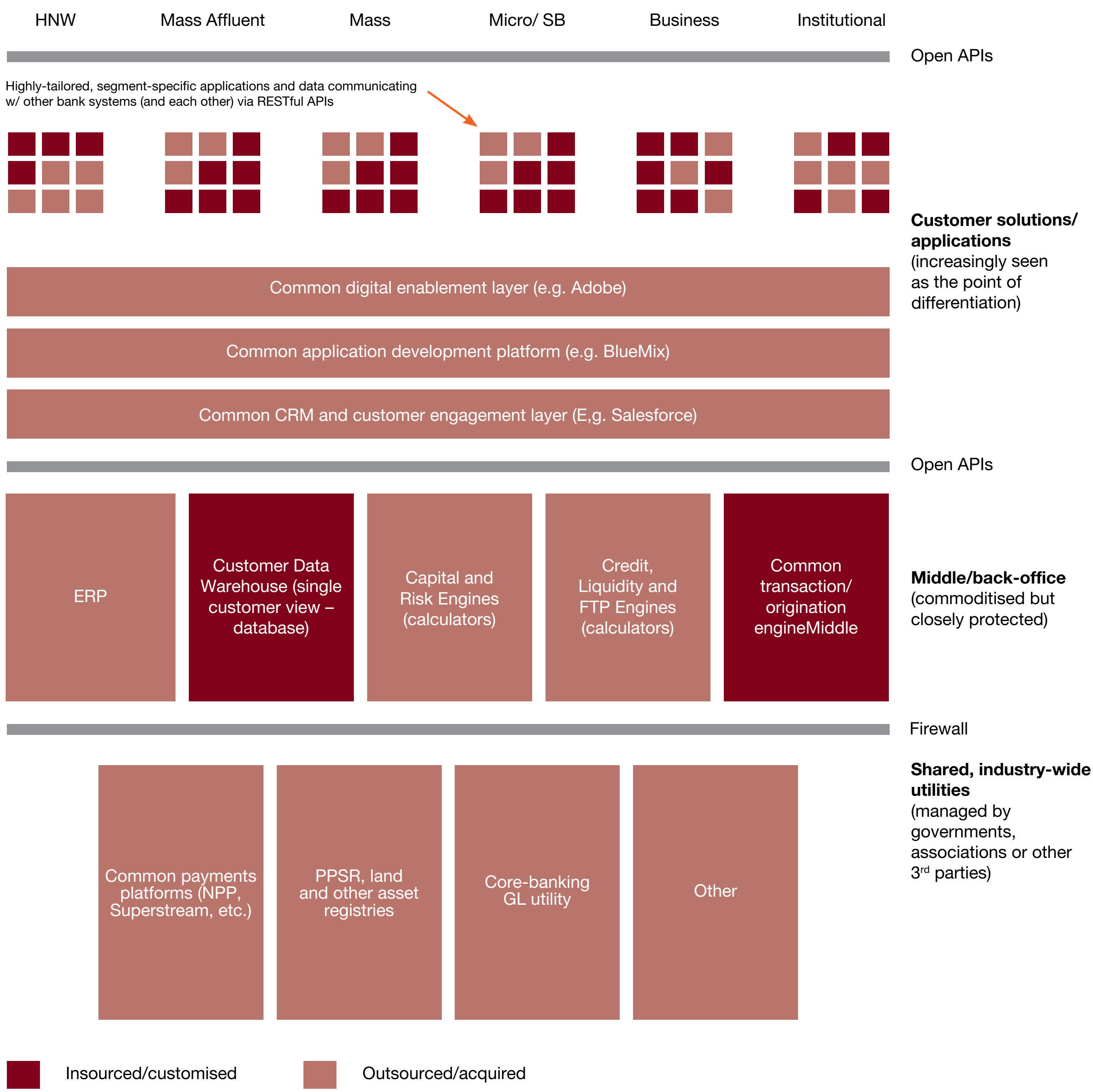
Banks are spending enormous sums maintaining large physical, technology and FTE footprints, but many customers would happily exchange this in return for being able to speak to someone at 10 pm on a Saturday. Again, just as with products, messages and channels, every situation is different. But when banks start with the customer and ask: *What is truly important to you*? and *Where do we truly differentiate?* the answers suggest that banks expend most of their energy on activities that don’t satisfy either criteria.

This is a highly contentious proposition in Australia. Value chain ‘decomposition’, whether through business-process outsourcing, offshoring or sharing, has a chequered history. Too many executives have been burned in the past by inflexible or unreliable providers, or impossible-to-manage industry consortia. Given the promise of digitisation and ‘robotics’ to streamline processes anyway, it may hardly seem worth the risk, at least without a near-term imperative to change.

But such an imperative may be coming. We have already shown that the economics of traditional banking in Australia are deteriorating, and we can see in Europe and the US how banks respond once the deterioration is sufficient. In fact, it is in continental Europe, where bank revenues fell 40 per cent after the GFC and never recovered, where 9 of 10 banks are still not returning cost of capital, that the most radical decomposition and restructuring of the traditional bank value chain has occurred.

In Switzerland, for example, 70 per cent of banks outsource application management and/or fulfilment, and are moving up the value chain from business process outsourcing (BPO) to knowledge process outsourcing (KPO), including things such as market research, collateral management and delinquencies. In Scandinavia, one bank decided to simply stop dispensing cash from branches. As a result, lines went down and customer satisfaction scores went up. Around the world, banks are collaborating to share such things as transaction banking platforms, customer reference data and other non-strategic but essential assets. In Germany, banks are partnering with insurance companies to share limited national balance sheet capacity by transferring long-dated assets such as mortgages to insurers whose liabilities are similarly long-dated. A decade ago, this would have been achieved through a complex and expensive securitisation intermediated by an investment bank in London. Today, it is arranged via a bespoke transaction between two longstanding counterparties at a much lower cost.

Figure 6: Streamlined, customer-centred IT



Consider again the organisation illustrated in Figure 5, explicitly aligned to customer segments. What would that imply about the ‘make or buy’ decisions relating to assets, people and operations, and their impact on the size of the organisation? What would its IT reference architecture look like? Perhaps something like Figure 6, with a customer-facing front-end, hosted in the cloud, comprising targeted application bundles, each curated to serve the needs of its segment. Almost everything could be outsourced to partners or shared industry ‘utilities’ with minimal customisation, including the product and general ledgers, KYC and customer identity, FATCA compliance, product fulfilment, credit scoring, trade collateral, loan security and delinquency management. What remains could be more tightly integrated and aligned to specific customer-segment needs, rather than to product or functional requirements. It could thus enable better exploitation of all sorts of synergies, such as for example that between credit, fraud and other op risk data, that may exist within the context of a specific segment, but are not evident when looking at the market more broadly. How different would this be from today’s product-centred information architecture and organisational silos? But to make this happen, banks must be prepared to unharness themselves from legacy assets accumulated over many decades.

Taking partnerships to the next level

The key is to streamline the *footprint*, not the service proposition. Partnering will be key, as will be elevating the skill with which banks manage partnerships. Too many banks cling to a ‘vendor management’ mindset when it comes to dealing with third parties. But a start-up or technology company capable of leveraging a bank’s data to deliver a compelling experience to its customers may not see themselves as a ‘supplier’ in the traditional sense. Nor will they want to deal with traditional procurement models – anchored as they often are around cost minimisation and commodity services. Fully leveraging partners to deliver for customers will require rethinking everything from supplier governance to IT architecture, security, and the rules and delegated authorities for business development and establishing commercial agreements.

The implications for IT are especially important. Currently banks in Australia are being pitched offers to replace 70s – and 80s-era technology with integrated systems designed in the 90s and refined in the 2000s. These systems were not designed to accommodate the cloud, the API economy, mobile apps, unstructured data or threats to cybersecurity that are orders of magnitude greater than owners of mainframe systems ever needed consider. Yet these are exactly the battlegrounds on which supremacy in digital banking will be won or lost.

It's not just about technology however. The most important and longest-standing partners for banks currently are the thousands of brokers and independent financial advisers who directly serve many of their existing customers, and the vast majority of likely new ones. For a bank seeking to streamline its footprint while improving its service delivery, effectively integrating these partners into their customer value proposition will be more important than ever. But banks struggle to do this even today, in part because they often disagree internally about the role these professionals should play. Are they, for example: (1) partners, (2) customers, (3) a variable-cost sales channel, or (4) a source of fill-up volume to close the gap between sales and plan? What role do third-party partners play in the sales-force effectiveness program? What about digital sales, or the contact centre strategy? Organisations that cannot provide a clear answer to these questions are likely to be missing out on opportunities to deliver the holistic experience their customers want.

Finally, it's not possible to have a discussion about streamlining the footprint without mentioning the future of branches. For decades, banks around the world have invested billions in making them appealing retail spaces. They have located them in prime high-street locations, offered free coffee and wifi, and installed ipads and sleek modernist furniture. Many banks around the world refuse now to even call them 'branches', preferring instead to call them 'stores', as Norwest (which merged with and became Wells Fargo) first did over 25 years ago. The vision was some sort of cross between Starbucks and an Apple store. Yet for the past two decades branches in almost all markets have consistently lost share to alternative channels: direct, online, mobile bankers and, most importantly, brokers, even at Wells. Perhaps it's time for a new paradigm.

Focus on specific areas of innovation

Every company in Australia knows that customer-led innovation is going to be crucial to compete in the years ahead. Banks are no different, and have deployed resources against this objective that one might expect would 'shock and awe' potential competitors and new entrants.

And yet they don't. Despite the considerable assets at their disposal, the fact-finding pilgrimages to Silicon Valley and Tel Aviv, the hackathons and hipster incubators, many believe large banks will be left behind. However, one should never underestimate the capacity of 100-plus-year-old institutions to adapt, and most banks are doing many of the right things already, including:

- promoting customer orientation – in all the ways discussed above

- fostering beneficial cultural practices and habits of mind – such as human-centred design and agile development practices
- giving accountability and authority to specific executives responsible for innovation and digital transformation
- deliberately encouraging greater collaboration with traditional and non-traditional partners, including technology companies, consultancies and start-ups.

Although the specific details vary (e.g. use of corporate venture capital, central innovation hub or distributed activities, 'Chief Digital Officers'), every bank we know is pursuing all of the above in some way.

What we would add to this list is the imperative for every organisation to make a few deliberate, strategic choices about the specific capability platforms on which they intend to build what we call *vectors of innovation*. Innovation doesn't happen in a vacuum, and it doesn't arrive totally by chance. It builds on itself and gathers momentum in specific directions as capabilities are built, lessons are learnt, and talent is attracted and nurtured. Its very nature means it's impossible to know exactly where it will lead, so banks do have to make choices about the areas where they want to build capability. Payments, cybersecurity, big data, analytics, voice recognition, cognitive computing, robotics, blockchain – these are all areas where there is much value to be created and new applications found. Authentication and digital identity in particular are areas with enormous immediate potential, as is making better use of banks' existing customer and transaction data. However, no institution can be best at everything. The largest global banks have cybersecurity budgets more than ten times larger than our majors do, and Google's is $3–4 billion per year. There is nothing wrong with choosing to be a buyer of someone else's expertise. One bank we know calls these areas their 'capability battlegrounds' and they spend a lot of time thinking (and arguing) about what's in and what's out. Every bank should.

Proactively embrace regulation

The fifth priority for banks is to rethink their approach to regulation, and to their regulators. This goes beyond having open, honest and collaborative regulatory relationships, something every serious institution we know already strives to do. It means explicitly recognising that Australia's reputation for sound prudential regulation, along with the Commonwealth's AAA credit rating, is one of the most valuable off-balance-sheet assets any bank has. Its value in terms of lower rates is impossible to know, and some have estimated that it could exceed AU$1 billion p.a. for the majors. Regardless, in a crisis it could be priceless. In short, it is a privilege to be a banker in Australia.

This is a privilege no one should take for granted. The quality of our regulatory landscape, and its reputation, is a shared public good. Rather than treating it as an exogenous business risk to be managed, banks and their boards should also recognise it as an asset to be nurtured and cultivated. Banks, on behalf of their shareholders, customers and other stakeholders, must become more proactive participants in the national conversation about our financial system, our public, corporate and household finances, and the individual and collective choices that influence them. They should recognise that APRA, ASIC and the RBA are in a unique position to overcome the *prisoners' dilemma* dynamics and antitrust considerations which can sometimes inhibit the industry from making changes that could be in everyone's interest. And they should establish credibility with the public by being seen to take positions that truly reflect the long-term stewardship obligations worthy of enduring institutions, rather than simply talking to their own books. As the focus of regulatory attention moves away from capital and balance sheet and towards questions of conduct and trust, the imperative to do this will only grow.

Of course, individual executives have always done this, as have banks and other institutions from time to time. Nevertheless, the conversation about the banking system in Australia might be very different today if the industry as a whole had been seen to do this consistently over a long time.

Put your culture to work

What can be more cliché than to add a point about corporate culture? We define 'culture' as the self-sustaining pattern of behaviours and beliefs that influence how things are done in an organisation. It is self-evidently central to organisational performance, a fact we implicitly acknowledge when we use phrases like *risk culture*, *service culture*, *innovation culture* and *execution culture*.

There is no bank in Australia we know whose leaders don't take culture extremely seriously. Most are doing many of the right things, including:

- articulating unambiguous values, purpose and mission, embedded within the corporate DNA through performance reviews, standing meeting agendas and internal communications

- setting clear expectations for each person in the organisation, with visible consequences and rewards for those who do or do not meet them

- reinforcing those principles, as best they can, through the individual behaviours of senior leaders.

Yet time and again we see capable and genuine executives struggling to get their organisations to deliver on their cultural aspirations. *Why?* Because unlike other success factors (e.g. business strategy, balance sheet), executives spend relatively little time honestly describing what their culture actually is – much less what they want it to be – beyond the common list of virtuous behaviours like *putting people first* or *doing the right thing*. These are worthy aspirations, but they are vague and say nothing about differentiation, links to corporate strategy or specific application. Our research on organisational leadership and culture, conducted over several decades, suggests that many organisations make this more complicated than it needs to be.

Rather than attempting to define and then impose some idealised view of 'culture' in an organisation, the most effective leaders start by ensuring they have a firm grasp on what their culture already is – what makes it distinct, and recognisable by those within it. They then articulate, using plain language and concrete examples, how those distinctions coherently reinforce their other strategic capabilities. Most importantly, they focus less on the qualitative outcomes they want to see and more on a small set of behaviours they believe will drive them – such as protocols for talking to customers, responding to messages, conducting meetings or performance management conversations. We call such behaviours the *critical few*, and it's crucial that there be just a few. The military is an example of an organisation that does this especially well. They recognise that carefully-chosen habits and rituals, reinforced with discipline and consistency can, over time, change mindsets, expectations and then self-belief.

The road ahead: escaping the commodity trap

Putting this all together, it is possible for Australia's banks to escape the commodity trap. In fact, it is possible for any company to escape the commodity trap, even ones that sell commodities.

Cement is a commodity. Yet Cemex has, over several decades, established a position as a uniquely competitive cement maker not just by efficiently making and distributing the core product, but by better understanding their customers in the building and construction industry and finding ways to solve problems for them that others don't.

Frito-Lay makes salty snacks, and have been a powerhouse for Pepsico because of the unique way they leverage their distribution capabilities to solve problems for their direct customers – the retailers who stock their product – and leverage research to give consumers a level of variety, surprise and delight they wouldn't normally expect from this product category. IKEA has done the same with otherwise generic, flat-packed particle board home furnishings, a market that has been completely reinvented by a company who took the time to imagine the end-to-end home outfitting experience and cater to it in a way that is also unique.

Companies like these have assembled what we call *capability systems*: processes, cultural attributes and other assets that they align to specific customer needs, in pursuit of a clearly defined corporate strategy.
In other words, their corporate strategy is *coherent*. What's more, because their approach to solving these needs is both unique and unprecedented, they have shifted customer expectations and changed the competitive landscape not only for themselves but for their competitors as well, forcing everyone to play by their rules. They are what we call *supercompetitors*. Amongst their many other virtues, they rarely have to compete on price.

Consider the phone in your pocket. Is it a commodity? Notwithstanding the fanatical loyalty of iOS or Android users, the fact is that almost all popular mobile phone apps or their equivalents are available on all platforms, work in similar ways and, when factoring in the hardware, data and accessories, are more expensive than people may realise. But that doesn't matter. Despite controlling no more than a sliver of the value chain behind the user experience, Apple, Google, Microsoft and others have managed to orchestrate a collection of services and weave them into customers' lives in ways that are uniquely personal and deeply integrated. Technically, their customer value propositions are almost identical. But they are sufficiently differentiated in consumers' minds – through brand mythology and narrative – to allow customers to self-select into segments of natural affinity. Once they self-select in this way and then incorporate the product into their lives, price becomes no more than a tertiary consideration.

Great brands are great not just because of the 'quality' of their products, the size of the market they attract, or their level of consumer recall. Sonos, Volvo, Rapha, Schwab, Vanguard, Chanel, Dior and Louis Vuitton are notable for the way they resonate with vividly-specific customer segments who self-identify with these brands to the point that they see them as their almost their only choice. Great brands don't aspire for five or ten percent of some national market – they seek sixty, or eighty percent of *their* market. The more banking becomes virtual, the more crucial it will be to have such a brand.

Few would use a service like infochoice, ratecity or iSelect to compare, application by application, the lifecycle cost of their home computing or mobile device. Yet thousands of people do that with their financial products every day, even relatively minor ones. Shrinking that gap in customer relevance, intimacy and identity, even just a little, is the great prize to be won in Australian banking in the years ahead.

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