Market dynamics are driving a fundamental shift in banking. Delivering productivity gains through a customer centric lens will be critical to success.

Productivity in Australian Banking

Sailing through the perfect storm

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Australian banks' profit margins are under significant pressure.

Executive summary

The Australian banking sector is facing a period of unprecedented change, instigated by a low growth environment, continuing global turmoil, regulatory change, pressure on profits and the rise of mobile technologies and social media being just some of the factors shaping the operating environment. These combined forces have flattened productivity and impacted banks' cost-to-income ratios.

Faced with these challenges, under a do nothing scenario, the Australian banks' profit margins could come down significantly, reducing profitability and ultimately impacting shareholder value.

Banks will need to adapt their business model to continue to drive earnings growth. The banking model of the future needs to develop as a result of a customer-based transformation, which encompasses a fundamental re-think of strategy, customer proposition, product, processes and functions.

Banks will need to fundamentally reshape processes to reduce the effort customers need to expend to engage with their bank, stripping out activities that are not aligned to the customer value proposition or that do not add value to the organisation.

This change will not be easy given the complex operational and organisational environment of many banks due to years of incremental and bolt-on changes.

However, banks that are prepared to change their operating model to be customer-centric will reap the rewards, with significant benefits to the bottom line from the synergy of both revenue improvements and cost reduction.

Introduction

Current landscape of Australian banking

A series of disruptive forces have come together to create the perfect banking storm, resulting in a period of extraordinary change that is challenging the current banking model. Importantly, this means banks are re-thinking their operating models to maintain profitability, boost productivity, preserve return on equity (ROE) and protect their share prices.

This paper explores current pressures in the Australian banking environment, the new operating model required for banks and ways in which that operating model will need to be implemented and optimised to counter margin loss and deliver benefits to the bottom line.

The forces outlined in the table on the opposite page have contributed to:

- deceleration of revenue growth – in the last year (FY10-11) operating income growth for the four majors dropped to 3.7% from over 10% in the previous year (FY10-11)
- flattening of productivity, which grew at 0.9% between 2009 and 2011, compared to average productivity growth of 4.7% between 1997 and 2008
- a 5% increase in the combined cost-to-income ratio of the major banks since the first half of 2009 which is up to 46.1% in the second half of 2011, from 44.1% in the first half of 2009.

Current dynamics in the banking environment: the perfect storm

Challenges facing the banking industry

Key Forces	Situation	Key Trends and Figures[1, 2, 3, 4, 5]	Impact and Risks
Low growth environment	• All segments of the Australian banking system facing a prolonged period of low growth – many at the slowest pace in over 30 years	• Housing: 2.3% six monthly growth • Personal (including credit cards): -0.2% six month decline • Business: 1.6% six monthly growth rate	• Slower asset and revenue growth
Dislocated wholesale market and liquidity	• Global turmoil impacting availability and cost of capital • Dried up securitisation market • Introduction of covered bonds • Decrease reliance in wholesale funding, potentially at risk • Increased competition for deposits	• Up to 100bp increase in the cost of certain types of long term debt • Deposits share of funding mix increased from <45% to >50% • 120 bp increase in deposit costs	• Increase funding costs • Pressure on margins
Increased regulatory requirements	• Significant number of new regulatory changes driven by BIS (Global), USA and local government agencies	• Australian: FCS, LAGIC, FOFA, NCCP Phase I and II, CCR, Super reforms, SIFI (living Wills) • USA: Dodd-Frank (including Volker Rule), FATCA • Global: Basel III, OTC Derivatives	• Lower product profitability (e.g. credit cards) • Increased capital requirements (e.g. mortgage line of credit) • Changed liquidity mandate • Disintermediation (e.g. derivatives) • Increased compliance costs
Re-platforming of the banks	• Complex and ageing legacy system environments	• Two major and one regional Australian bank replacing core banking platforms • Targeted replacement of other integral systems across all major banks	• Program costs and risks • Risk of decreased ability to compete for those who do not follow
Changing customer behaviour and mobile technologies	• Phenomenal adoption rate of new technologies by Australians driving a fundamental shift in how consumers research, buy, interact, and discuss their experiences with financial products	• 50% penetration of smartphones • 24% penetration of tablets • 13 million internet users over the age of 15 (64% shop online and 97% research online) • Highest facebook penetration in the world • 62% of internet users use social media	• Challenge how banks monitor, develop and manage their brand, including increased overhead costs • Risk of loosing customers by not engaging through emerging channels/media
Disintermediation and increased competition	• Lower entry barriers as a result of technological change enabling new competitors to handpick segments or elements of the value chain and customers to tap markets directly	• New competitors such as Tyro (merchants) and paypal (payments) and Asian banks leveraging the retreat of European banks • Disintermediation: payments (platform providers going to large corporates directly), institutional lending	• Reduced product take up rates and cross-sell • Reduced profitability

Fundamental shift in the business and economics of banking

The risks are high. According to the most recent Banking Banana Skins report by the Centre for the Study of Financial Innovation (CSFI) and PwC, banking executives, analysts and regulators cite macroeconomic risk and liquidity respectively as the #1 and #3 key risks facing banking. Political interference and regulation respectively were cited as the #2 and #4 risks. The impact of these challenges can be significant. PwC analysis suggests a do nothing scenario could impact profit margins considerably and ultimately hurt shareholder value.

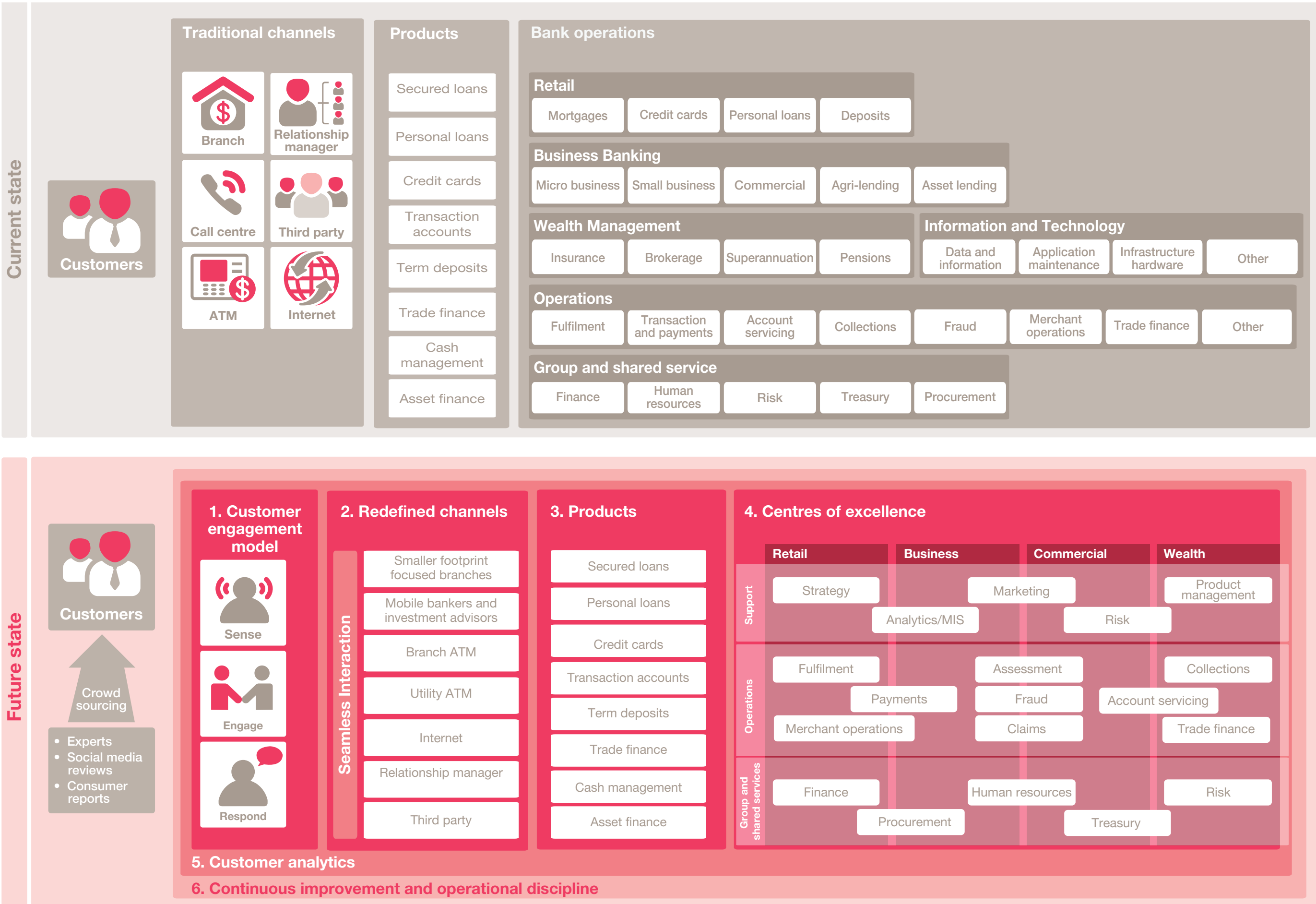
For a broader global perspective on the key forces and trends in Financial Services please refer to PwC's Project Blue.

Customer-centric productivity is critical to continue to drive growth and ROE targets.

The future of Australian banking: customer-centric productivity

The Australian banking model of the future is a streamlined customer-centric organisation, which comprises six key components:

Current versus future banking model



1. Customer engagement model

The customer is king

In Australia's highly mature financial services market a disproportionate share of future revenue growth will come from retaining and growing the current customer base. In an environment where service expectations are increasingly set by non-financial competitors, the customer engagement model (CEM) will be used to sense issues and un-met needs and engage the right part of the bank to address these needs.

Banks that develop a CEM with a rigorous focus on customer experience and continuous improvement will enjoy a significant competitive advantage.

Leading banks will develop a deep understanding of the critical interactions that drive customers' perception of service, that is, 'moments of truth', and the drivers of customer effort and advocacy. This understanding will enable banks to improve response rates and sales conversions, customer retention and cross/up sell, while increasing referral rates and brand value.

A successful customer-centric bank will shift the focus away from financial products (for example 'I need a mortgage') to customers' end needs (for example 'I want to buy an investment property'). This will facilitate a redefinition of how banks engage with customers. For instance, they will support their customers by providing rental management software or real estate seminars in areas with a high proportion of investment properties.

2. Redefined channels

The era of convenient banking

In the banking model of the future, channels will align to products, customer involvement and customer preferences.

Product characteristics driving channel preferences

Type of Purchase	Characteristics	Sample Products	Likely Channels
Low involvement	Commoditised products that require less or minimal effort or consideration prior to purchase, typically of lower value	Transaction accounts Term deposits High interest deposit accounts Credit cards Some personal loans Simple mortgages (refinancing) CTP car insurance	Mobile Online
High involvement	Less commoditised, higher value products that require long and careful consideration	Complex mortgages (e.g. first home owners) Investments Insurance (life)	Mobile face-to-face (brokers, mobile bankers) – likely to be multi-channel

Mobile and online channels will capture the majority of low involvement purchases, as more complex transactions will continue to require face-to-face contact. However, this does not mean customers will go to branches. Currently, more than 60% of new home loans are already sold through mobile channels (brokers and mobile bankers). Customers will increasingly prefer to manage these interactions in places and at times that are convenient to them, further driving these transactions to more flexible channels.

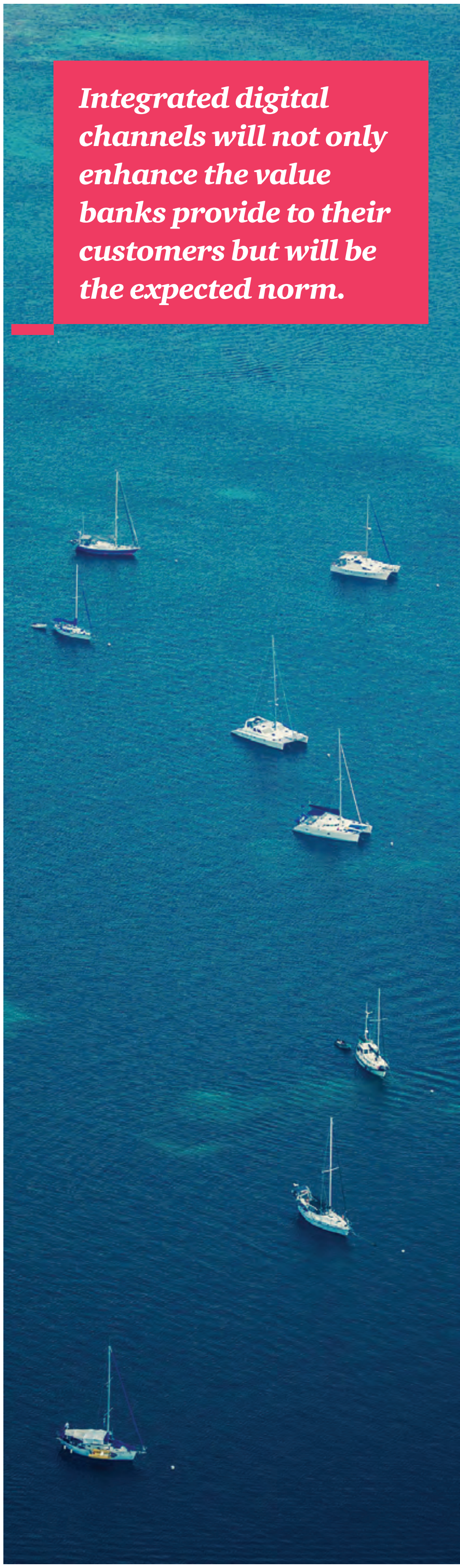
A robust and effective digital presence including mobile and online will handle the vast majority of transactions which, together with processing excellence, will eliminate errors and re-work, shifting work away from branches and call centres.

Therefore, the branch of the future will be smaller and focused on complex, high value purchases and will provide value-added services tailored to the needs of the community they service, such as information about how to fund renovations in neighbourhoods where there is a multitude of first home buyers. The Royal Bank of Canada and CIBC in Canada already offer services of this type.

Critically, digital, phone and face-to-face channels will need to be integrated, enabling customers to seamlessly shift between channels. Integrating the digital experience will give banks the ability to access services and experts through click-to-chat and video conference facilities such as Skype, greatly enhancing the value banks provide customers, particularly in remote locations. In the US, Quicken Loans has already developed a strong non-branch service offering that fully integrates internet, call centre and click-to-chat.

Moving forward, banks will continue to be challenged by customers' increased expectations of online and mobile services as they compare banks to leading digital product and technology providers.

Integrated digital channels will not only enhance the value banks provide to their customers but will be the expected norm.



3. Products

Monetising value by re-assessing pricing and bundling

Changes in the regulatory environment and technological developments require a re-think of banks' product portfolios. Basel III will make certain products unviable in their current form. For example, mortgage lines of credit will require higher capital, driving up costs and rates, as banks will likely start charging for undrawn lines, potentially limiting this product to a niche private bank offering. Term deposits (TDs), in particular business TDs, will be negatively impacted by new liquidity rules. Derivative products have already been impacted by the Dodd-Frank legislation in the US.

Successful banks will need to develop new products or re-design existing ones to comply with emerging regulations. For example, minimum terms and/or restrictions on withdrawals are likely to be introduced on business deposits.

Banks will re-evaluate how products and services are priced and bundled, giving them an opportunity to monetise convenience, volume, behaviour and data quality. Banks may charge for services customers now receives 'for free' – for example for exceeding a number of transactions performed on a mobile or for access to more personal channels for customers who have no-frills products.

Banks will also be able to extract relevant transactional data and customer trend information and provide this information to business customers to enhance customer loyalty or drive new avenues for revenue.

To do this, leading banks need to break-up current products and features and re-aggregate and bundle them to extract value. Technology investments will be required to enable banks to make many of these changes.

The bank of the future will differentiate its offering by having a focused product set, better aligned to the customer value proposition. This will help improve customer satisfaction by eliminating confusion and improving employee knowledge, as well as reducing operational complexity by offering fewer products and services.

Finally, banks will also investigate and implement new channel-specific product bundles that include tailored functionality such as online spending tools and information storage.

4. Operations, shared services and support functions

Optimised centres of excellence

The bank of the future will be organised around centres of excellence (COE) that cut across business and product silos. This transition will assist in creating a leaner organisation and will optimise operations across people, processes and technology. The COEs will consist of three areas:

Functional centres of excellence

Type of functions	Sample business areas	Opportunities	Example
Shared services	Human resources Finance Procurement	Further centralisation Streamlining offerings Eliminating shadow functions Multi-functional shared service environment	Standardising services offered by finance and eliminating many of the reports used
Operations	Fulfilment Credit Assessment Payments Collections Fraud Servicing	Further integration across disparate business units Automation of manual processes Elimination of customer effort and non value added activities Streamlining process end-to-end vs. within silo	Consolidating of wealth management and insurance operations with the rest of banking operations
Business and support functions	Strategy Analytics and MIS Product management Marketing Risk	Consolidating across businesses Improving baseline capabilities Leveraging of leading practices	Many banks are already centralising the risk function to make it more productive

Each of the COEs needs to be optimally managed and operated as efficiently and effectively as possible. In many instances this will be enabled by straight-through-processing (STP) to speed up delivery of services and minimise errors. The COE structure will allow more appropriate sourcing and offshoring, enabling banks to reduce rent and labour costs.

5. Customer analytics

The key to unlocking value

Analytics will create a better understanding of the customer lifecycle, as well as customer needs, preferences, behaviours and purchasing patterns.

Aggregating customers into discrete segments will help banks better understand how to sell and service these segments. Analytics will provide banks with improved insights into the key drivers of:

- customer, household, segment and product profitability
- customer lifetime value and attrition
- channel performance and value
- risk profile of customer, industry, regions, products, and businesses
- portfolio profile and sources of value
- transaction costs and value.

Analytics and insight will produce quick and effective decision making, enabling investment in areas that will drive sustainable, profitable growth and shareholder value. This understanding will help improve pricing, product and bundling decisions. Furthermore, a robust analytical capability will enable banks to focus marketing efforts, reducing marketing spend while increasing its effectiveness. By improving the relevance of campaigns banks will be able to grow revenue by lifting the number of appointments booked, show rates and, ultimately, sales conversion rates.

Unlocking the value of analytics will require banks to capture real time information and insights and action on these through the appropriate channel and at the right time to make positive impacts on customer experience.

6. Continuous improvement and operational discipline

Embeding change into the DNA

The DNA of successful banks will include a culture of continuous improvement and incorporate strong operational disciplines.

Maintaining this culture over the long term will require a robust approach to managing both customer experience and cost. The new customer engagement model with a focus on reducing customer effort will help establish continuous improvement into the organisational culture, as will the focus of the COEs on optimising their operations.

Critical to sustainable growth will be robust operational disciplines. Successful banks will need to have strong leadership, supported by the right policies and procedures. Accountability and execution will be driven by cascading targets and behaviours into key responsibility areas (KRAs) that link to performance management frameworks. This will be supported by transparency and reporting that is aligned to strategic objectives.

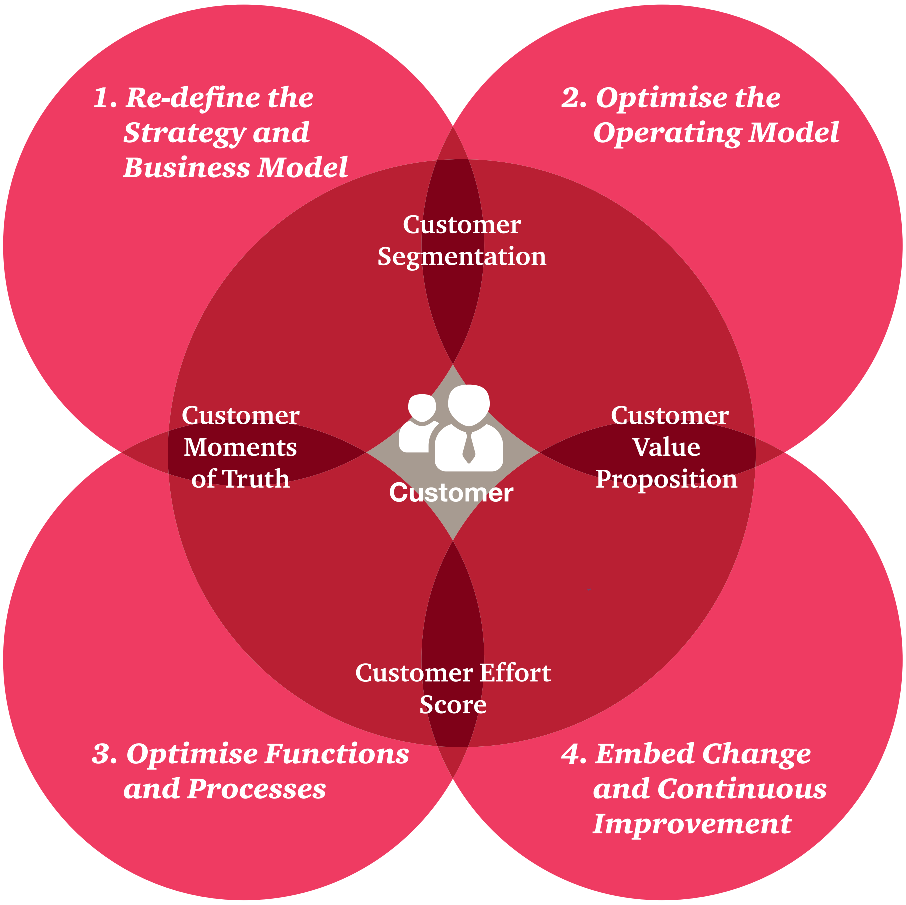
Analytics will provide valuable insights into the customer and will enable quick and effective decision making for management.

Customer-centric transformation leads to simplification

The journey towards the bank of the future will not be easy, particularly in light of the internal complexity that is currently evident across many banks' operating environments. The past 30 years has seen unprecedented growth in customer segments, products, channels and businesses. Many banks have made these changes incrementally, building on top of or separate to current structures. This had led to a proliferation of complexity in processes, technologies, interfaces, business silos and supporting organisational structures, making it hard for banks to react to external pressures.

This complexity means transformation is required. Traditional, internally focused transformation efforts take minimal consideration of customer experience, yielding improvements on a short- to medium-term basis. Unfortunately these efforts are not sustainable and require new cost reduction programs every couple of years. What is worse, frequently this approach creates a vicious cycle where incremental cost reduction negatively impacts customer experience, hurting long term profitability.

Customer centric productivity



It is ironic that customer experience and cost reduction are typically seen as conflicting agendas. Our experience suggests it is the only way to achieve sustainable growth.

PwC's experience highlights that the path to the future is through customer-centric transformation. It is ironic that customer experience and cost reduction are typically seen as conflicting agendas. Our experience highlights that pursuing this dual objective is not only achievable, it is the only way to sustainably drive growth and profitability. Success will hinge on fundamentally re-thinking the business model and operating environment, rather than incremental change.

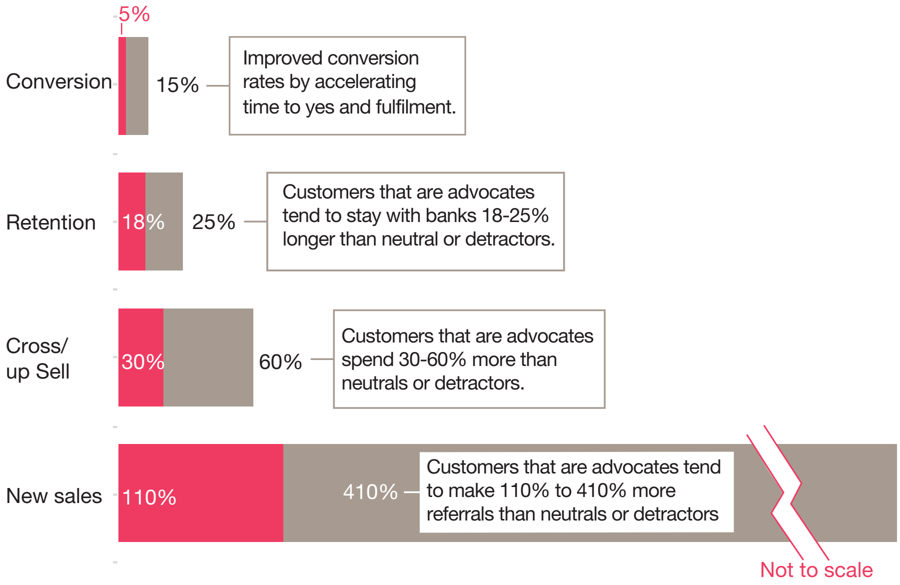
Banks that pursue a customer-centric agenda will see significant improvements in customer experience and costs. Reducing customer effort will result in improved processes which in turn will streamline bank operations. For example, in our experience, banks can increase conversion rates by up to 5% -15% and reduce fulfilment costs by up to 20% - 30% by reducing the effort required by customers to open a lending account. Continuous focus on improving the customer experience will help streamline processes, improve cycle times and eliminate non-value added activities.

Improving the operational disciplines in managing the sales pipeline from inquiry through to loan completion will enable banks to improve conversion rates and gain valuable insight into why customers drop-out prior to completion. Proactive communication with customers at critical points in the pipeline can also reduce inbound calls.

Operational excellence is critical. For example, accurately completing all steps in the loan establishment process, including the set-up of direct debits, reduces customer complaints and the effort to investigate first payment defaults. This leads to increased customer satisfaction.

The combination of customer centricity and operational excellence enables banks to improve the acquisition process of new customers. In turn, advocacy will increase, leading to improved retention rates and greater potential to cross-sell and up-sell.

Revenue benefits of customer centricity



More broadly, a customer-based transformation requires a fundamental re-think of strategy. A customer-centric organisation is a focused organisation. Business units, segments, products and/or channels that neither align to the Customer Value Propositions (CVPs), nor meet key risk adjusted return hurdles should be rationalised. Driving this simplification will have significant benefits.

For example, many banks have very complex product portfolios. In our experience up to 70% of banking products are at best only marginally profitable or have very low take up rates. This complexity negatively impacts operations and technology costs, risk, customer experience and employee satisfaction. Rationalising these products could reduce costs by more than 15% and improve the customer experience by up to 20% - 30%.

The journey will require banks to question many precepts currently taken for granted. Current assets could become a hindrance if their future role is not challenged and their evolution not thought through carefully, including the role of branches.

Banks that make this transition, optimising channels, automating processes, delivering with excellence, redesigning products and breaking organisational silos will obtain significant benefits. In PwC's experience, this could deliver step change in cost, lift operational improvements and enhance the customer experience.

Success will be handsomely rewarded. PwC estimates the potential earnings impact of becoming a customer centric organisation will be substantial for each of the major banks, on top of current tactical cost reduction initiatives.

Case study: delivering growth through an enhanced customer-centric process

One of the largest banking and financial services institutions in the world recognised that it needed to transform the way it interacts with its customers in order to meet its stretch growth and efficiencies targets. The bank wanted to enhance the breadth and depth of engagement with customers in a cost efficient and effective manner. To achieve its objectives the bank realised they needed to transform their operating model to become a truly customer centric organisation.

A critical focus of this change program was to develop a streamlined and consistent sales approach. This enabled the bank to reduce the effort required by customers and therefore making it easier for them to do business with the bank.

At the same time, the bank identified how hard and time consuming it was for sales people to find relevant customer, product and pricing information and recognised the negative impact of poorly defined sales management roles and responsibilities. Streamlining these activities and addressing the "time thieves", enabled the bank to focus the effort of sales staff and significantly increased the time available for sales and customer value-add activities.

The bank also identified that existing sales operational and management structures did not lend themselves to handling global opportunities and deals. To drive performance, it was clear the bank needed greater consistency in its sales approach as well as better sales tools and support to improve the depth of customer intimacy and, subsequently, lift sales conversion.

By focusing on the customer and enabling the organisation with the right support, focus and tools to execute, the bank has been able to drive a step change improvement in customer experience and subsequently financial performance. The bank has already reported early, positive results and the business is confident it will achieve the anticipated sales uplift of more than 20% per annum, whilst improving the efficiency and effectiveness of the organisation.

What next?

There are no short cuts on the journey, however from PwC's analysis the benefits are worth while pursuing. Commitment and leadership from the top will be essential. As will strong alignment with longer term objectives, strategies and clear accountabilities. Comprehensive program structures will be required to support the change program. Banks will need to build a clear end-state vision for the business, taking into account the evolution of financial services and build a plan to deliver the vision, breaking down the effort into manageable parts. Execution will require hard work and expertise in a range of disciplines including a deep understanding of customers and organisational, process and transformation expertise. The effective transition from a program to the business will be critical, as will robust analytics to support decision making and management and financial disciplines including embedding objectives into performance management and reporting.

We can help

PwC has an extensive track record working with banks to drive large complex productivity programmes anchored on customer centric transformations. Our teams leverage deep functional and industry knowledge from across the firm to deliver sustainable change outcomes for our clients.

pwc.com.au/consulting/productivity

If you'd like to learn more about Productivity in Australian Banking, please contact Glen, Arturo, Andreas or Laurence.

Glen Noonan

Financial Services Transformation

E: glen.noonan@au.pwc.com
P: +61 (3) 8603 6426

Arturo Mauleon

Banking Strategy and Productivity

E: arturo.mauleon@au.pwc .com
P: +61 (2) 8266 3357

Andreas Skopal

Financial Services Customer Experience

E: andreas.skopal@au.pwc.com
P: +61 (3) 8603 4545

Laurence Dell

Banking Transformation

E: laurence.dell@au.pwc.com
P: +61 (3) 8603 2151

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Brad McBean
Michael Codling

Of further interest

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