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Financial Services

The Italian Financial Services market competitive arena

How to get high returns in Financial Services

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Foreword

Powerful forces are reshaping the financial services industry globally. Customer expectations, macro-economic trends, technological capabilities, regulatory requirements, demographics and economics are together creating an imperative to change. The Italian market is not immune from this process.

Financial institutions need to get ahead of these challenges and retool to win now and beyond. They must not only execute on today's imperatives, but also transform themselves for the future.

Disruptive new entrants are gradually winning share by offering innovative customer experiences through new products and channels.

The future will require financial institutions to be agile and open, ready to explore different options in an uncertain world. Financial institutions have developed staggeringly complex and costly business and operating models. Now they must simplify.

Leading players will have to develop a much more complete understanding of their customers and reduce their product set, and so deliver a better customer experience with lower levels of operational risk than today.

Customers now generate exponentially more information than ever before. Winning financial institutions harness both structured and unstructured information – from traditional and new sources of information such as social media, and cross-channel bank customer interaction data.

In this paper, we will look closely at the evidence and the facts related to the Italian Financial Services market including all the players working along the financial services value chain from regulated financial institutions providing banking and insurance products to independent distributors supporting the client facing activities, and to business process and IT outsourcers.

This working paper offers the reader a different point of view of the Italian market also thanks to the professional experiences gained by Strategy& and PwC at large in this area. It has the ambition to become an ongoing observatory, able to capture the key market and competitive dynamics, collecting insights and points of view of the different players in the industry.

Executive Summary

Italian financial services: a market full of opportunities still working out the NPE legacy of the financial crisis with a long journey towards customer experience and operational excellence

Italian financial services show several peculiarities and characterisations vs. main European countries

- lower access to credit (41% as loans on GDP vs. 52% of EU average for households and 58% vs. 75% for corporates) but higher weight of non-performing exposures (7.9% on total loans vs. 3.0% of EU average);
- higher households' wealth (financial assets on GDP equal to 254% vs. 225% of EU average);
- higher penetration of life policies (GWP on GDP +2 p.p. vs. EU average) but lower penetration of P&C products (GWP on GDP 1.7% vs. 2.3% of EU average).

Both banking and insurance operating income suffered in the last 10 years (respectively, -58% and -17%), affecting ROE (from 9.5% to 5.6% for banks and from 12.5% to 6.9% for insurance companies).

Italian economic cycle has been struggling in recovering, and therefore in the recent past the effort of many leadership teams was strongly absorbed by the balance sheet, in particular by credit quality issues.

Analysing the market in depth, not all players active in the financial services competitive arena are the same. Five sub-segments seem to outperform the rest of the market in terms of profitability and market valorisation with double-digit ROE and P/BV significantly higher than 1x. Those are: financial advisors, independent distributors, payments specialists, debt servicers, BPO/ITO players. However, the "micro" perspective remains crucial: "winners" can be found across all segments also in apparently less attractive areas.

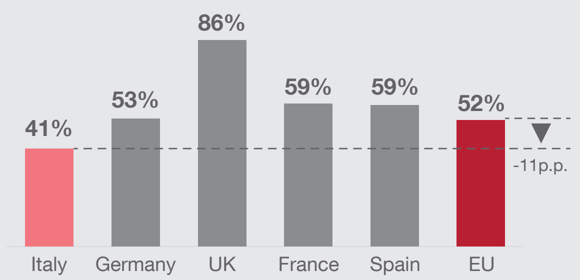
Hybrid (offline-online) is the winning model in this new business environment but there are no crystal clear success stories of offline native players moving to online, yet.

Banking and insurance players are more and more focusing on core business and this is driving a growing demand for outsourcing, enlarging the overall business pool within financial services (new players and new services).

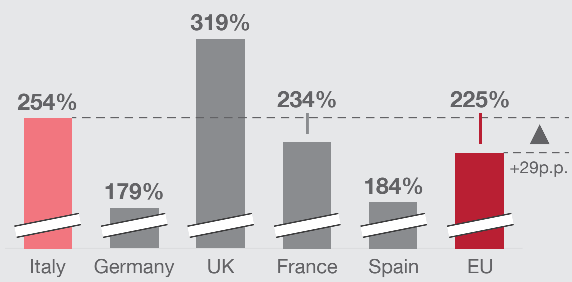
For most of players in the financial services competitive arena, a lot of work must be done to really set the compass for growth and success: promptly addressing customer's needs, specialising, moving towards hybrid models, winning the talent war and rethinking the cost base.

Financial services in Italy present peculiarities on access to credit, asset quality, held assets and insurance penetration

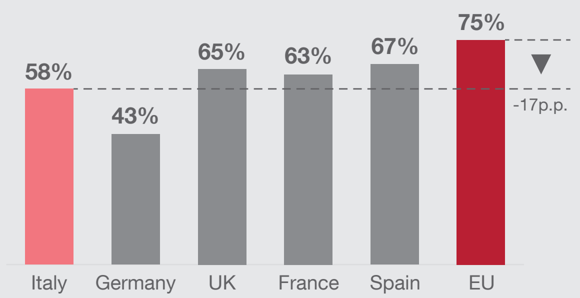
Loans to households (% of GDP) (2018)



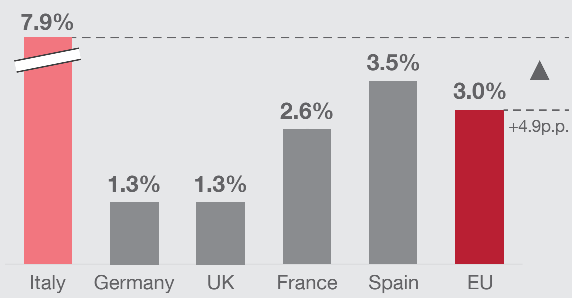
Financial assets[1] of households (% of GDP) (2017)



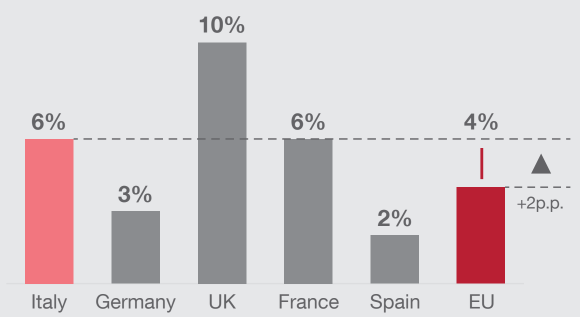
Loans to Non-financial corporations (% of GDP) (2018)



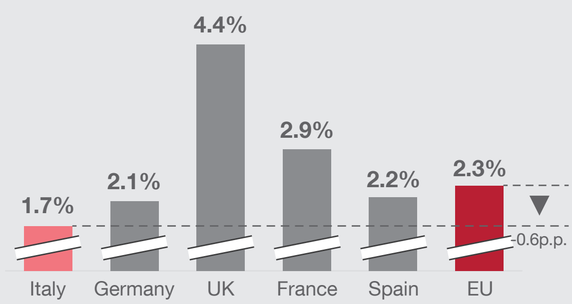
Non Performing Loans[2] (% of Loans) (1H-2019)



Life policies' gross written premiums[3] (% of GDP) (2018)



P&C policies' gross written premiums[3] (% of GDP) (2018)



Sources: Eurostat, Istat, InsuranceEurope, Efama, EBA. Europe refers to average data of the 28 member States
(1) Financial assets: Currency and deposits + Debt securities + Loans + Equity and investment fund shares + Insurance, pensions and standardized guarantees + Financial derivatives and employee stock options + Other accounts receivable/payable
(2) Gross carrying amounts, other than held for trading
(3) Not including Health Insurance premiums

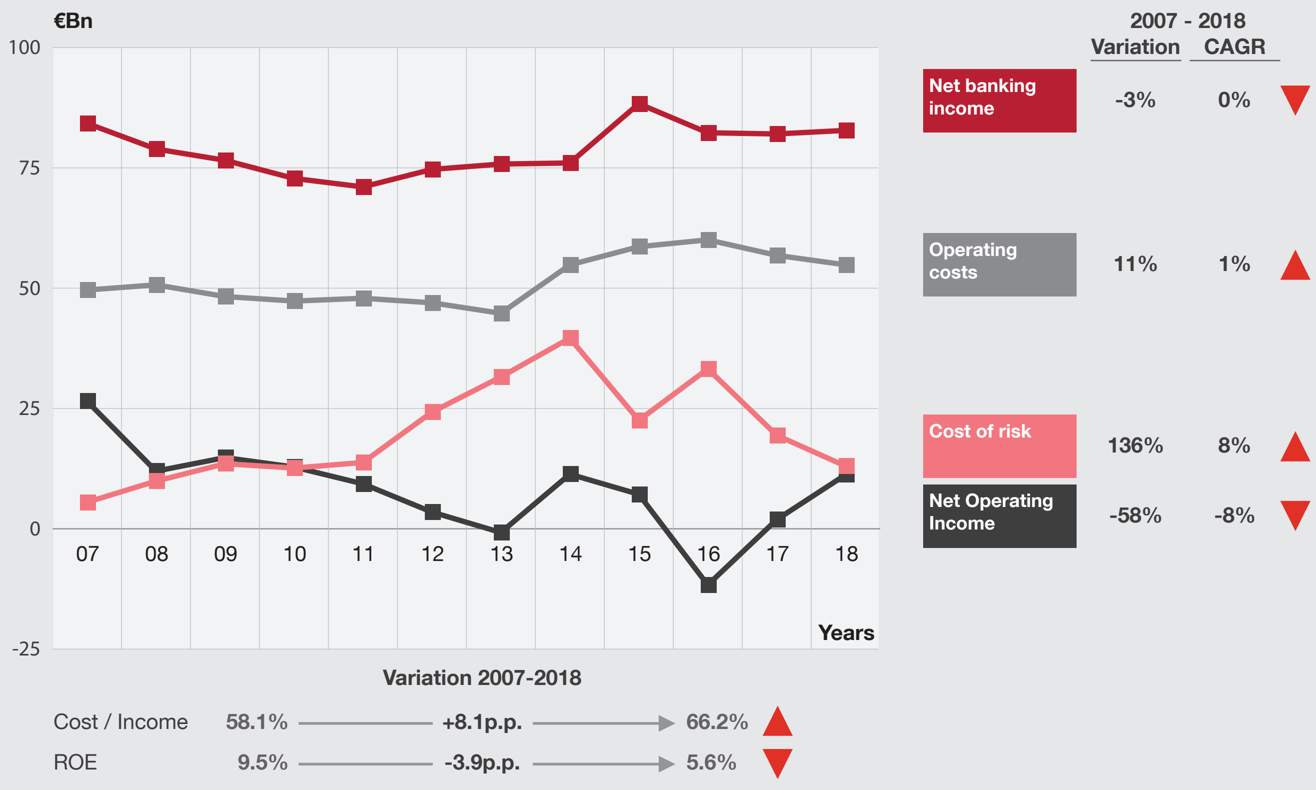
Italian Financial institutions are facing six key challenges in the current environment

Challenge		
1 «Low» interest rates	**1.40%** (-40bps vs. 18) Average interest rate on residential mortgages[1]	**1.30%** (-16bps vs. 18) Average interest rate for corporate lending[1]
2 High client expectations	**95%** Banks expected to be able to digitally acquire customers within 3 years[2]	**130** Banks signed the UN-sponsored commitment to 'sustainable finance'
3 New competitors	**25%** Specialty finance assets held by specialist players (not part of main banking groups)[3]	**€2Bn** Volumes of alternative lending provided since inception at June 2019[4]
4 NPE problem not totally solved	**165€Bn** Volumes of non-performing exposures in the Italian financial sector[5]	**7.9%** (+4.9 p.p. vs. UE average) Ratio of gross non-performing loans on total stock[5]
5 Tough regulatory environment	**Ongoing "Tsunami" of new regulations** AML, MiFID2, IFRS9, Basel IV, Solvency II, CRD5/CRR2, Business Model Analysis, PSD2, IFRS 17, FinTech Regulation, ...	
6 Systemic risks persistence	**31-Jan 2020** New deadline to finalize the UK's withdrawal from the EU	• Hong Kong protests • Syria war • US vs Iran front • Trump potential impeachment • Tariff wars

Sources:
(1) ABI Monthly Outlook «Economia e Mercati Finanziari-Creditizi» - November 2019. Data as of Oct-19
(2) ABI Lab: «Banche: l'acquisizione dei clienti diventa digitale»
(3) Strategy& analysis on Banca d'Italia, ASSOFIN, ASSIFACT and ASSILEA data
(4) P2P Lending Italia
(5) Bank of Italy and EBA Risk Dashboard. Data as of June-19

Overall banking net operating income have been suffering in the last ten years, with positive upturn since 2016

Evolution of key figures of Italian banking system (2007-2018)[1]



After subprime mortgage crisis:

- **Net Banking Income** slightly decreased in absolute terms with net interest margin substantially unchanged. Net fees increased their weight in the revenue mix from 26% of revenues in 2007 to 38% of revenues in 2018. Vice versa, other revenues (mainly from trading activity) halved.

- **Operating costs** reached their highest value in 2016 (+21% from 2007) and in the last two years (2017-2018) are positively decreasing (CAGR -4%), but Cost / Income is still at high value

- **Cost of risk** is more than doubled from 2007 to 2018, reaching its top of 40 €Bn in 2014. In the last two years, thanks to non-performing loans disposals and more cautious disbursement processes, the quality of the loans has improved. However, NPL ratio level is still higher than European average (8% vs 3%)

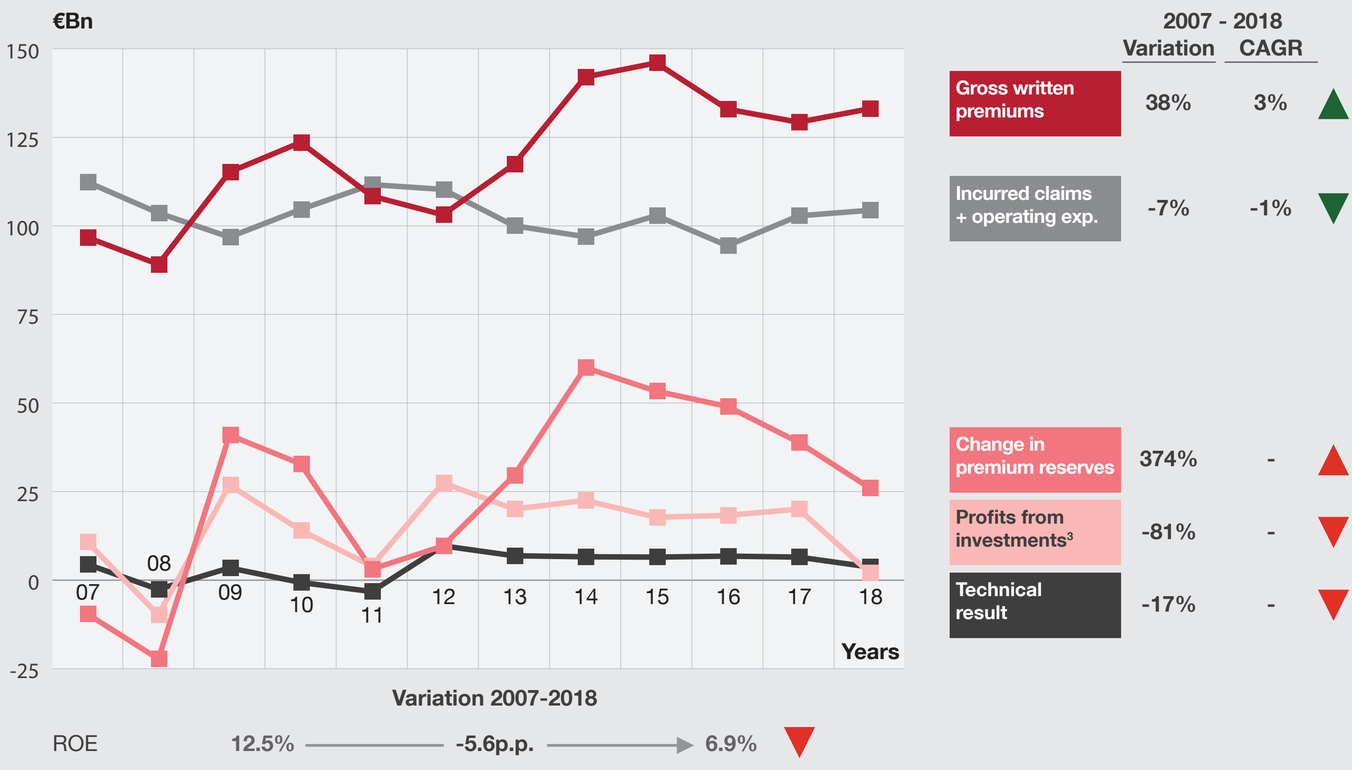
The combined effect of these three dimensions led the net operating income to very far results from pre-crisis levels (ROE 2007 9.5% vs 2018 5.6%).

In the last 2 years the operating result has been recovering mainly thanks to the cost of risk reduction and widening spread between Net banking income & Operating costs.

(1) Source: Banca d'Italia – "Relazione annuale – Appendice" from 2007 to 2018. Banking system: banks and banking groups with a PLC holdings, banks and banking groups with a popular bank holding and cooperative banks. Foreign banks branches are excluded

Also insurance market "suffered" in spite of a growth of GWP and improvement of P&C combined ratio

Evolution of key figures of Italian insurance system (2007-2018)[1]



After the 2008 financial crisis **overall technical result** has decreased (2018 vs. 2007: -17%), mainly due to:

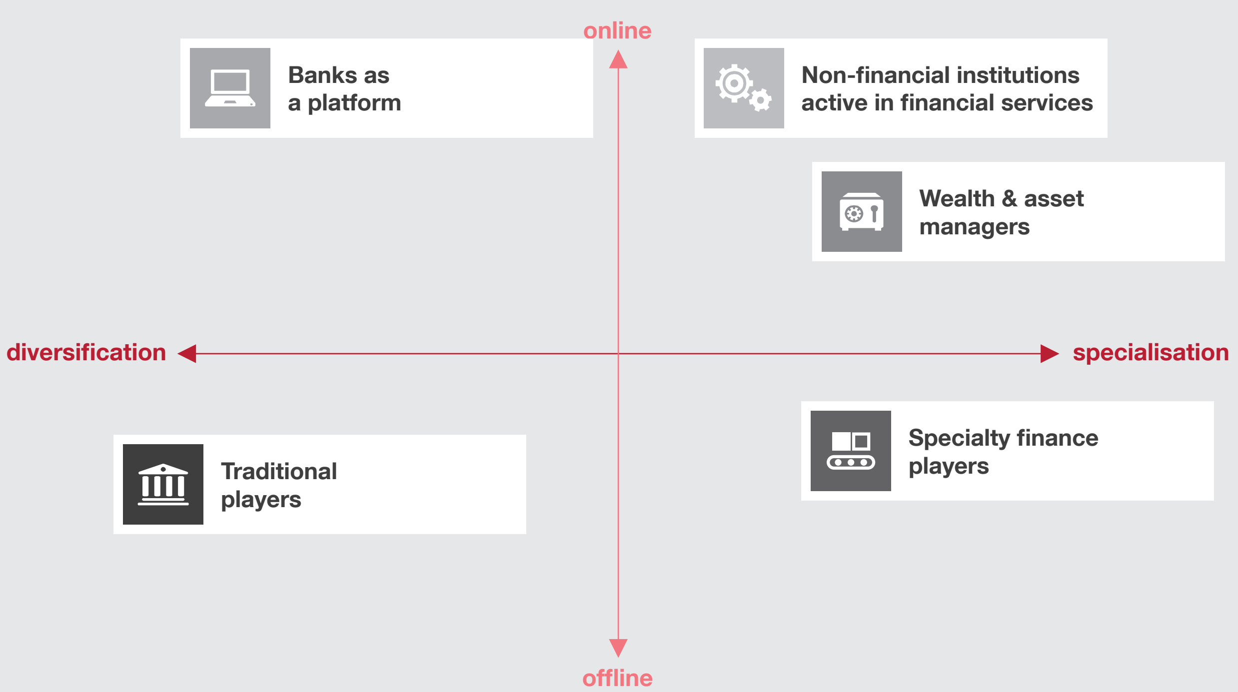
- **Life premiums reserves** strongly increased (2018 vs. 2007: +352%), with a higher pace compared to GWP of Life business (2018 vs. 2007: +67%)
- **Combined ratio**[2] of Property and Casualty (P&C) business improved in the last 11 years (2018 to 2007: -4.5 p.p.), mainly due to i) an increase in the weight of better performing P&C - Non Motor LoBs on overall P&C business (from 43% of 2018 to 51% of 2007); ii) a decrease of the combined ratio of most of P&C - Non Motor LoBs (e.g. General TPL went from 107% of 2007 to 69% of 2018)
- **Profits from investments** strongly reduced both for P&C (2018 vs. 2007: -61%) and Life (2018 vs. 2007: -86%)

The combined effect of the factors stated above, jointly with a worsening non core other income and expenses going from -950 €Mn of 2007 to -2.5 €Bn of 2018, resulted in a decrease of Net Profits (2018 vs. 2007: -21%), that in turn contributed to reduce ROE (that went from 12.5% of 2007 to 6.9% of 2018).

(1) Source: Ania
(2) Sum of Incurred Claims and Operating Expenses divided by GWP
(3) Not including non-technical insurance accounts

According to the breadth of the offering and distribution model five distinct macro-business models can be identified

Financial services macro-business models



Two dimensions of analysis are set for mapping Italian financial services macro-business models:

- breadth of the offered product range (horizontal axis)
- distribution channel adopted (vertical axis)

According to these two dimensions, five macro-business models are identified:

1. **Traditional players:** generalist banking groups, with strong product diversification, for which the physical channel remains predominant, and insurance companies;

2. **Specialty finance players:** players focused on high-yield and / or low-risk specialised credit products (leasing, factoring and consumer credit);

3. **Wealth & assets managers:** segment composed by financial advisors and asset managers;

4. **Non-financial institutions active in financial services:** "unregulated"[1] world, with effective alternative channels for business originators and a marked online spirit, such as:

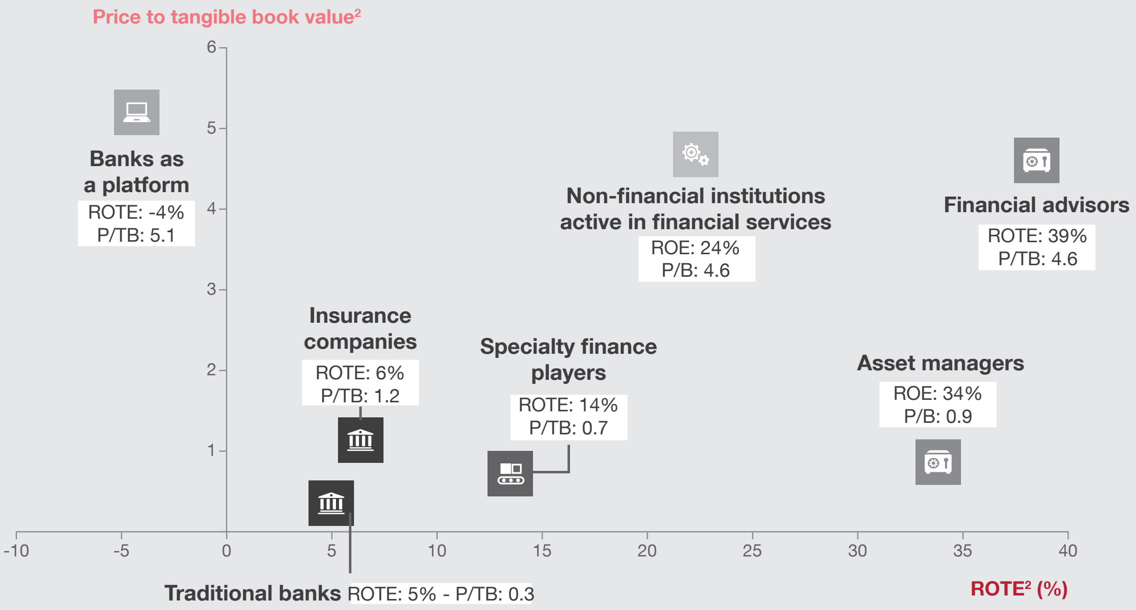
   – **Payments Specialists** – focused in receiving and processing payments
   – **Independent distributors** – acting as amplifier for other businesses (e.g. insurance agents, lead generators)
   – **BPO and ITO players** – enabling clients to streamline operations and increase flexibility
   – **Debt Servicers** – specialised in handling credit collection processes for third parties[2]

5. **Banks as platform:** Digital native banks (in some cases with hybrid models) that approach the market as open platforms that give their customers the possibility to access a wide range of third-party products.

Source: Strategy& elaboration
(1) Players not included in banking (Banca d'Italia) or insurance (IVASS) registers
(2) Also including players with banking / financing intermediary license for master servicing and debt purchasing activities

Each macro-business model shows material differences in terms of profitability and market value

Players profitability and market values by segment - Median values of the selected sample - data as of 30.06.2019[1]



For each Italian financial services macro-business two drivers have been quantified:

- profitability, in term of "return on tangible equity" (ROTE)[2] - horizontal axis
- market expectation, in term of "market value / book value" (Price to tangible book - equity - value) - vertical axis

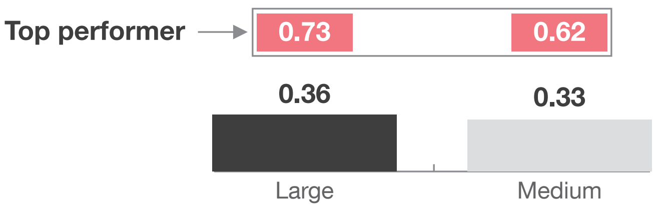
According to these two values, macro-business are represented as follows:

1. **Traditional players:**
   - **Traditional banks:** low profitability levels, far from pre-crisis; strongly affected by NPE legacy of financial crisis; joint with high non-performing loan weight that penalize the stock market multiples
   - **Insurance companies:** better positioned than banks, but still at low levels of profitability and market value
2. **Specialty finance players:** strong results and better-valued by the market compared to traditional banks;
3. **Wealth & assets managers:**
   - **Asset managers:** light capital requirements which allow very high levels of profitability
   - **Financial advisors:** higher market value compared to asset managers, despite higher capital requirements
4. **Non-financial institutions active in financial services:** unregulated (no capital requirements) with very high level of profitability, very well appreciated from the market;
5. **Banks as platform:** in a startup phase (still with negative results), high successful expectations from the market.

Source: Strategy& analysis
(1) Data as of 30.06.2019 or, if not available, at the most recent previous date
(2) Book value: equity value gross of intangible assets for Asset Managers and Non-Financial institutions active in financial services

Market does not seem to recognize a price premium to Large banks

Focus on traditional banks market valuation (Price to tangible book value)



Traditional banks are divided in 2 categories

- **"Large"**
  - Total assets: ≥ 100 €Bn
  - Revenues: ≥ 5 €Bn
- **"Medium"**
  - Total assets: ≥ 10 €Bn ∧ < 100 €Bn
  - Revenues: ≥ 200 €Mn ∧ < 5 €Bn

Markets on average recognize similar values, compared to tangible book value, to Large and Medium traditional banks.

Market does not seem to reward (yet?) certain distinctive factors that characterize Large banks than Medium ones:

- higher overall profitability (ROTE: Large 5.7% vs Medium 4.5%) with a significant gap also considering the top performer of each of the two groups (ROTE: Large 10.7% vs Medium 9.2%);
- better cost efficiency (OPERATING COSTS / TOTAL ASSETS: Large 0.85% vs Medium 0.96%) determining a 68.0% Cost Income vs 68.5% of Medium banks, gap amplified looking at top performers (L 47.6% vs M 61.4%);
- higher portion of "change" costs on total IT costs (RUN vs CHANGE investments mix: Large 55%-45% vs Medium 59%-41%);
- adequate "fire capacity" to face the challenge of innovation (average IT CASHOUT per year: Large 1 €Bn vs Medium 0.15 €Bn).

Going forward, we expect that medium-size banks will be more under pressure than larger players and, as a consequence, profitability gap vs larger banks may increase. However, Medium banks can activate different levers to fill this gap:

- smart specialisation, leveraging white-labeling solutions or partnerships with fintechs;
- lifelong learning, investing in distinctive competences and talents;
- M&A consolidation/ creation of investment sharing platforms, increasing efficiency and reducing the weight of ICT investments.

Source: Strategy& elaboration on 30.06.2019 data and last available CIPA-ABI report

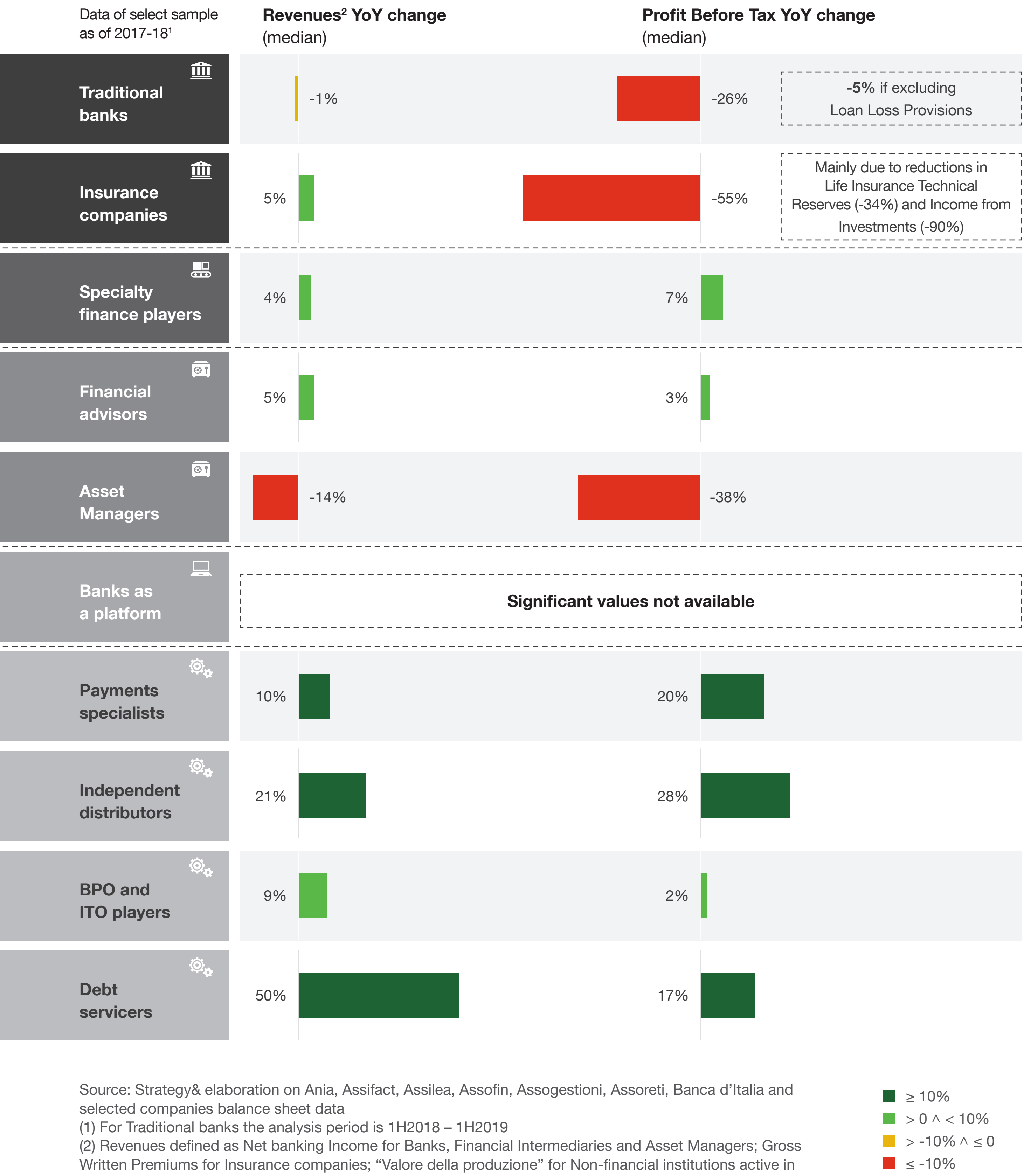
In the past year, business volumes grew in most of financial services segments

Segment	Key business volume indicator of the segment	Reference values 2017[1]	Change	Reference values 2018[1]
Traditional banks	**Loans to customers** (new production – GBV in €Bn)	412	+2%	420
Insurance companies	**Yearly gross insurance premiums** (€Bn)	129	+3%	133
Specialty finance players	**Leasing, factoring and consumer loans** (new production – GBV in €Bn)	223	+11%	248
Financial advisors	**Financial Assets of Households** (€Bn)	4,218	+4%	4,374
Asset Managers	**Assets under Management** (€Bn)	1,245	-3%	1,212
Banks as a platform	**Number of customers of mobile-only banks** (#Mn)	**Exponential growth** Precise figures not available yet		
Payments specialists	**Card-based transactions** (#Bn)	3.4	+16%	3.9
Independent distributors	**Number of brokers/ agents/ collaborators** (k#)	21.8	+7%	23.4
BPO and ITO players	**Top banking groups' IT costs**[2] (€Bn)	4.0	+6%	4.2
Debt servicers	**Assets in servicing** (GBV €Bn)	285	+31%	373

Source: Strategy& analysis on Bank of Itay, Ania, Assogestioni, Assoreti, CIPA-ABI, ISTAT and OAM
(1) For "Traditional banks" the analysis period is from 2H2017-1H2018 to 2H2018-1H2019
For "Financial Advisors" and "BPO and ITO players" the analysis period is 2016-2017
(2) Total cost of ownership of 17 banking groups

- ≥ 10%
- > 0 ∧ < 10%
- > -10% ∧ ≤ 0
- ≤ -10%

Last available trends show important growth for specialists and service providers



Source: Strategy& elaboration on Ania, Assifact, Assilea, Assofin, Assogestioni, Assoreti, Banca d'Italia and selected companies balance sheet data
(1) For Traditional banks the analysis period is 1H2018 – 1H2019
(2) Revenues defined as Net banking Income for Banks, Financial Intermediaries and Asset Managers; Gross Written Premiums for Insurance companies; "Valore della produzione" for Non-financial institutions active in financial services

Higher profitability and higher market values are achieved by specialist players and service providers

Data of select sample as of 2018[1]	Profit Before Tax/Revenues (median)	Profit Before Tax/Revenues (max)	ROTE[2] (median)	ROTE[2] (max)	Price to tang. book[2] (median)	Price to tang. book[2] (max)
Traditional banks	15%	25%	5%	11%	0.3	0.7
Insurance companies	3%	7%	6%	39%	1.2	1.5
Specialty finance players	47%	74%	14%	28%	0.7	2.3
Financial advisors	47%	57%	39%	52%	4.6	7.2
Asset Managers	69%	85%	34%	75%	0.9	n.m.
Banks as a platform	-101%	n.a.	-4%	n.a.	5.1	n.m.
Payments specialists	16%	20%	38%	57%	4.2	n.m.
Independent distributors	11%	36%	45%	120%	6.2	6.7
BPO and ITO players	7%	52%	11%	71%	5.6	6.7
Debt servicers	27%	49%	19%	28%	3.8	4.8

Source: Strategy& elaboration on Ania, Assifact, Assilea, Assofin, Assogestioni, Assoreti, Banca d'Italia and selected companies balance sheet data
(1) For Traditional banks the analysis period is 1H2019
(2) Book value: equity value include intangible assets for Asset Managers and Non-Financial players

Main Takeaways

1 Five outperforming segments	• **Five segments** – Financial Advisors, Independent distributors, Payments specialists, Debt servicers and BPO and ITO players – **are outperforming** the rest of the market thanks to the following, sometimes combined, peculiarities: – **No NPE legacy of financial crisis** – **Specialisation** – **Native online business and operating models**
2 «Micro» perspective is always crucial	• In most of segments there are **players with high profitability and high market value**, but **also in most outperforming segments there are some weak players**; • Open your eyes wide to **find «best underperformers» and transform them into market leaders** through specific actions.
3 Path from offline to online: who comes first?	• Hybrid is the winning business model but there are **no success stories of offline native players moving to online**, **yet**; • **Different transformation works are in progress**.
4 Growing demand for outsourcing	• Banks are continuously facing **challenges to reduce overhead costs and enhance operational efficiencies**; • As a result, we are observing **an increasing use of outsourcing**.
5 Several niches with high potential	• In each business sub-segment it is possible to identify **market niches with high potential**; • **Traditional players** are often not able to exploit market niche potential, **leaving room for new players** entrance.
6 Do not escape from risks	• **Traditional banking players were strongly burdened by NPE legacy of financial crisis and in the last years in some cases had** the **tendency to avoid risk** minimising exposures with negative impacts on business volumes and margins; • **Managing actively risks** represents an opportunity for traditional and new players in terms of **profitability and business growth**.

Set the compass for growth and success

For most of players in the financial services competitive arena, a lot of work must be done to really set the compass for growth and success. Top strategic priorities are the followings:

	Tactical	Strategic
Customer first	• Introduce Customer driven KPIs • Digitize customer Journeys • Adopt cutting-edge CRM solutions	• Enhance data analytics capabilities to identify customer needs • Redesign core business processed to improve customer experience
Business/ geographical/ customer specialisation	• Introduce white label products • Develop partnerships with «active» fintech • Cultivate smart pricing	• Sharply focus on a select set of "core" businesses • Optimize/ simplify the offering • Launch specific ESG compliant products
Get "Fit For Growth"	• Adopt capabilities zero-basing: budget from scratch • Outsource "me-too" activities • Reimagine core processes and journeys, front to back	• Continuously ensure and address cybersecurity • Create a performance culture • Modularize process architecture
Towards hybrid models	• Integrate online and offline customer experiences	• Develop a lead generation machine with online and offline channel feed • Make customer data available on each channel and real time
Winning the talent war	• Train resources with identification of differentiated and specialised paths • Embark in digital up-skilling programs to increase motivation and productivity	• Recruit/ retrain of talents to meet changing needs • Promote life-learning programs • Stimulate workforce entrepreneurship and self-reliance

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For Further Reading

- Business model analysis: quali strategie per vincere la sfida della redditività
- Building a commercially viable European payments model: A transformation agenda for generating revenues and reducing complexity
- Specialty Finance Challenger Banks in Italy: reshaping the lending landscape?

Strategy&

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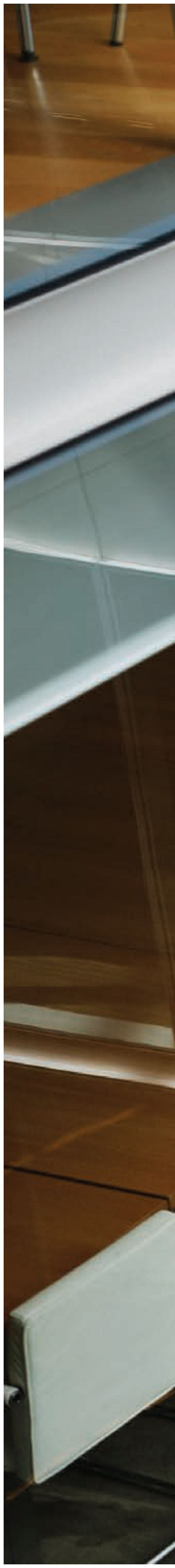

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