Getting the balance right

How European banks can maximize their full potential in retail
The Strategy& Retail Banking Monitor is an analysis of the leading European, North American and Australian retail banks across key performance dimensions. The 2019 edition contains a sample of about 50 retail banks and banking groups across 11 markets using data gleaned from 2018 annual reports. Market share coverage in these markets ranges from close to 50 percent to above 90 percent, and the sample includes traditional branch-based banks as well as direct banks of relevant size and profit and loss account.
EXECUTIVE SUMMARY

Just over a decade on from the financial crisis, many European banks are still struggling in their retail businesses with an environment of low interest rates, a shrinking branch network, stiff competition and high acquisition costs for new customers.

The return on equity at banks in the eurozone was 6.2 percent in 2018. While that was slightly higher than the previous year, it was still about half of pre-crisis levels, according to the European Central Bank.

Such pressures mean banks have been largely focused on maintaining a low cost-to-income ratio (CIR) – that is, keeping costs as low as possible while trying to grow market share.

Yet we think this approach has led banks to focus insufficiently on “per customer” performance metrics, which are a better measure of profitable long-term customer relationships with staying power. That’s important, because doing higher margin business with existing customers is the most promising path to profitable growth over the long term.

Indeed, cross-selling or selling premium products to existing customers is far more efficient and profitable than acquiring new customers through means such as offering cash incentives to open new accounts. That’s particularly true at a time when the market and revenue pool for European retail banks is stagnating, competition from digital competitors is fierce and the number of customers switching banks is low.

While CIR remains an important measure of profitability, we think the time has come for a new approach to improving profitability: banks should spend less on acquiring new customers, but instead should invest in creating and selling products and services to their existing customer base to capture the full potential of each customer relationship – while keeping costs low.

Our model shows that this has the potential to boost revenue per customer by as much as €200, from €435–€580 currently. Having a balanced CIR of between 53 percent and 65 percent is key to achieving this.

In this 2019 Strategy& Retail Banking Monitor, covering about 50 retail banks and banking groups across Europe, North America and Australia, with a combined 715 million customers and an estimated €17.1 trillion in retail deposit and loan volumes, we found that the best-performing retail banks were the ones that were most successful in capturing the full potential of each customer.

By following the recommendations we make below, banks can make themselves what Strategy& calls “Fit for Growth”, generate sustainable profits and be more robustly prepared for a future financial crisis.

* Strategy&'s Fit for Growth approach is a proven model for unlocking performance that helps companies manage their cost in a more strategic way, allowing them to cut costs and grow stronger at the same time. Fit for Growth is a registered service mark of PwC Strategy& LLC in the United States.
Key findings

1. The highest operating profit per customer was achieved by banks that kept a balanced CIR of 53 percent to 65 percent. However, fewer than half of banks in our survey had a balanced CIR. And only 13 percent managed to translate such a balanced CIR into profits greater than €430 per customer.

2. The best-performing banks generated over €1,100 in top-line income, and operating profits of around €400-€500 per customer, compared with only double-digit operating profits per customer for the worst performers.

3. Banks in countries with the lowest CIRs, such as the Nordic region (average CIR of around 47 percent), generated reasonable yet lower operating profit of about €240 per customer on average.

4. Banks that managed to grow their top-line income (2017 vs 2018) grew profit on average by about €35 per customer, while costs rose by around 3 percent.
Performance by market

Capturing profits in European retail banking markets

Switzerland is in a category of its own because it has more than double the loan volumes of other markets. That is because of the way mortgages are taxed, because banks tend to have relatively more wealthy individuals as clients and because prices charged for services have been relatively high.

Italian banks have average operating profit per customer of about €290, which is among the highest in Europe, thanks to consolidation of the banking sector, cost management and above-average pricing power.

Belgian, Dutch and Spanish banks are managing to capture adequately their market potential based on the proportional relationship between the size of their economies and the assets of the bank.

Banks in other countries have struggled to turn the potential of their markets into the profits that the relative wealth of the respective country would indicate.

Source: Strategy& Retail Banking Monitor 2019
Get fit by investing in “good” costs

EXHIBIT 1
Cost-to-income ratio (CIR) impact on operating profit
(2018 data, individual bank level)

Operate profit per customer (€)

Balanced CIR for highest profits

“Good” costs to tap market potential

“Bad” costs prevail

Colored areas indicative
- Germany
- Switzerland
- Italy
- UK
- Netherlands
- Spain
- USA
- France
- Australia
- Nordics

Bubble size indicates operating income per customer

Source: Strategy& Retail Banking Monitor 2019
As shown in Exhibit 1, banks tend to achieve the highest operating profit per customer when they operate under a balanced CIR of 53 percent to 65 percent. That is, they spend wisely to capture the top-line potential of their customer base.

To be sure, banks that do this sacrifice the benefits of a very low CIR. But they gain a credible long-term profit and growth story because they have invested in “good” costs. They have rationalized their branch networks, invested in higher-margin products and gone digital.

We have used proven, real world examples to show how banks can reach this “sweet spot” of a balanced CIR and high or growing profit per customer, using three strategies, depending on where a particular bank sits on the CIR spectrum:

• “Protein for the skinny”: drive top-line income and invest in “good” costs. Banks with a low CIR and low operating profit per customer should create top-line growth and spend wisely on good costs to reach their profit potential (banks on the left in Exhibit 1). We estimate that these banks could improve profit per customer by €50-€60 on average.

• “Fitness program for the sluggish”: capability-driven strategic transformation. Banks with a balanced CIR that is not translating into high profit per customer should undergo a strategic transformation focusing on their strengths and the capabilities that differentiate them, to tap into their profit potential (banks in the lower middle section of Exhibit 1). We estimate that banks here could increase profit per customer by €35-€45 on average.

• “A diet for the overweight”: strategic cost-cutting. Banks with the right overall positioning but a CIR that is too high – above 65 percent is our rule of thumb – should apply a strategic cost-cutting/efficiency program to get rid of unnecessary spending while protecting good costs (banks on the right in Exhibit 1). We estimate that banks here could improve profit per customer by €40-€50 on average.
A. Protein for the skinny

Doing as much business with your customers as you can – beyond providing basic products such as current accounts and cards, which generally bring in to the top-line only around €200 per customer per year – is the key driver of additional revenue generation. Exhibit 2 below illustrates the impact of business volume on top-line income.

EXHIBIT 2
Business volume impact on operating income and profit per customer
(2018 data, weighted averages)

Banks with a low cost-to-income ratio but with profit that lags industry leaders should focus their attention on growing customer business in both lending and deposits, offering customers more than base products and going all-in on digital investments. Here are five levers to pull to drive top-line income:

Be the main bank for your customer
Taking the current account as the product at the heart of the client relationship, banks should provide a focused range of products and services tailored to the needs of their customers. These fall into four broad categories: savings and investments, loans and mortgages, payments and transfers, and insurance.

German co-operative and savings banks pull this lever in exemplary fashion. All these banks cater to a wide range of their customers’ needs, acting as their main bank and managing everything from deposits to mortgages and pension provisions as well. Société Générale in France and KBC in Belgium are examples of a type of bank that has made a success of generating relatively high operating margins through selling insurance-related products under a bancassurance model.
Get base product pricing right
Ensure your basic products are profitable by not bundling too many services into one basic offering, but instead taking a modular approach so that customers can choose what they need. This will increase the number of customers who use your current account and avoids the danger of giving away basic accounts free.

Eliminate legacy special offers (e.g. free checking accounts), at least for customers who don’t use the product anymore. Banks should also consider adding a charge for in-branch services, as some banks have done in Ireland for some years, to steer customers towards online banking.

When it comes to premium banking products, the tech industry offers the best example of “anchor pricing” – that is, showing customers the highest-priced product alongside a mid-priced product, which makes the mid-priced product look like good value (which it may well be). This can help to move customers up from the most basic offering to the more profitable mid-price segment.

And don’t be shy of high prices: premium offerings are also perceived as valuable. For example, many French banks have achieved high market penetration with a credit card with an annual fee of around €140. This is still significantly cheaper than a more premium offering, which carries a fee of around €340 per year.

Offer investment products
Since the financial crisis, retail customers have gradually rediscovered capital markets products – equities, bonds and exchange-traded funds (ETFs) in particular – thanks to persistently low savings interest rates. More banks should take advantage of this. Comdirect, a German direct bank, has a brokerage offering that is part of a multi-product offering that generates relatively high commission income.

Grow the loan business
Loan margins have been at rock bottom for some time. Funding costs cannot be significantly lowered while European interest rates remain low and are only likely to increase slowly. To generate top-line growth, cautious and balanced growth in mortgage lending as well as in higher-margin consumer loans should be targeted to keep a healthy mix of interest and non-interest income.

Seize digital opportunities
To stay relevant, banks should master at least three of the most important innovation challenges: “mobile first” (like Belgian bank Belfius, for example, which established its digital strategy in 2015 based on a mobile-first approach); providing a seamless cross-channel customer experience (like the German savings banks, with their new core banking software systems); and leveraging open-banking opportunities.

Pulling the five levers described above might require investment in products, services and digitization, however spending for the right reasons will benefit the bottom line. If these five levers are applied successfully, we estimate that, on average, up to €50–€60 of additional profit per customer could be realized.
B. Fitness program for the sluggish

While around 30 percent of banks within the optimum CIR range earn profits of more than about €430 per customer, roughly 70 percent of banks within this balanced CIR range are not realizing their top-line potential despite considerable costs and investments (see middle lower part of Exhibit 1).

Most of the remaining 70 percent of banks are tending to pursue a variety of short-term initiatives that seem to promise growth, without carrying out a solid strategic evaluation of which opportunities will lead to sustained success and putting in place robust processes to see them through.

By contrast, the 30 percent of banks that are doing well in terms of revenue per customer tend to have performed a strategic transformation in recent years and have established the value proposition they want to achieve, or have decided what kind of bank they want to be. They then have translated that into a coherent transformation roadmap, based on a clear product and service offering and the distinct capabilities needed to deliver it. These are the key steps to take:

Know where to play
Banks in this situation should evaluate their value proposition – what it is that makes them attractive to customers – and scrutinize their current business model to determine, for example, whether they should be a specialized or universal bank.

Refine product and service offering
Banks should assess and potentially re-align product and service portfolios based on how each component contributes to the bank’s overall value proposition. This includes add-ons for customers such as mobility services – car ride-sharing, for example – working spaces or even career services, which could deepen the relationship and increase cross-selling and up-selling potential.

Upgrade capabilities
Specialized banks have to build a distinct set of capabilities, which typically would include integrated data management and analytics, automated servicing, smart cross-channel management and integration, and a smooth integration of external data and partners (e.g. fintechs).

Deliver the changes
When banks become preoccupied with their own organization, they may miss market opportunities. That’s why, when carrying out a transformation, banks must clearly formulate a roadmap that includes quick and mid-term wins, and pursue this effectively instead of spending years on inward-looking projects (e.g. organizational transformation, regulatory requirements, long-term IT projects).

We estimate that “sluggish” banks that follow these steps could earn, on average, up to €35–€45 of additional profit per customer, while maintaining a balanced CIR.
C. A diet for the overweight

With two large European banking markets – France and Germany – displaying average CIRs close to or above 70 percent and having low operating profit per customer (€100-€200), there is some urgency to cut costs. Strategic investments to generate top-line income should begin once the work on costs has started to show results. To be “Fit for Growth”, banks should focus efforts on a 10-step plan, divided into three areas:

1. Portfolio and capability choices (the “what”)

<table>
<thead>
<tr>
<th>Portfolio rationalization</th>
<th>Focus on products that are central to the bank’s strategy, e.g. reduce product and segment variety/complexity. Reducing product number and variants by 30 percent is possible.</th>
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<tbody>
<tr>
<td>Capabilities “zero-basing”</td>
<td>Make choices on which differentiating capabilities the bank should focus on and which capabilities it should eliminate.</td>
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</table>

2. Organization and location (the “where”)

<table>
<thead>
<tr>
<th>Operating model design</th>
<th>Banks should focus on the areas making substantial profit and find the optimal balance between centralization and regionalization.</th>
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<tr>
<td>Outsourcing/offshoring</td>
<td>Banks need to outsource non-differentiating activities and leverage the low cost of near-/offshore labor.</td>
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<td>Footprint optimization</td>
<td>The density of the branch networks varies widely across Europe: roughly 5,100 customers are served on average by one branch in Germany compared to 3,900 per branch in France, 23,800 in the Netherlands, 22,500 in the Nordics or Switzerland with 7,000 per branch. The number in Germany is extremely low and a clear cost driver.</td>
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Italian bank UniCredit started a restructuring program in 2016 called Transform 2019. It focuses on transforming business and operating models, including streamlining and simplifying products and services and optimizing “spans and layers”. The program has resulted in the closure of 30 percent of the bank’s branches and significant staff reductions. Digitization and IT transformation have been key enablers.
### 3. Operational excellence (the “how”)

<table>
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<tr>
<th><strong>Organizational right-sizing</strong></th>
<th>Banks need to think about their optimal organizational structure and streamline “spans and layers”.</th>
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<td><strong>Process excellence</strong></td>
<td>Banks should strive for radical optimization all the way through the value chain, with a client-centric approach to upgrading the internal/external customer experience. They should also work to streamline regulatory and compliance processes.</td>
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<td><strong>IT leverage</strong></td>
<td>For internal cost savings and efficiency, large-scale process automation and artificial intelligence (AI) are needed. Many of the European markets with high CIRs face challenges from relatively high personnel costs or expensive legacy IT systems, due to previous hesitancy over investing in substantial technology transformations. Nordic banks Swedbank and DNB have put huge emphasis on end-to-end digitization of all core processes by using AI-based solutions such as virtual robots. Swedbank, which is transforming itself into an agile and digitally-driven organization, has closed more than 30 percent of its Swedish branches over the past three years, introduced a new digital banking group and merged its IT operations with business units and corporate functions.</td>
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<tr>
<td><strong>Way of working</strong></td>
<td>Becoming agile, where it makes sense, allows banks to increase speed, quality and customer value generation, and reduce risk in new projects. Some Dutch and German banks are embracing this, even though short-term results are not reflecting it yet.</td>
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<tr>
<td><strong>Supply management</strong></td>
<td>Revamping procurement for expense reduction and restructuring the supplier landscape.</td>
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If these measures are applied successfully, we estimate that, on average, up to €40–€50 additional profit per customer could be realized.
Conclusion

Top-line growth and maximizing operating profit per customer offer retail banks the best route towards sustainable growth in the short and long terms. Our analysis shows that spending too little limits banks’ ability to do this, and that a balanced CIR is better than having the lowest.

Wherever a bank is now on this journey, these changes will make it fit for growth and enable it to achieve sustainable industry-leading profit into the future.
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Strategy&

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