<table>
<thead>
<tr>
<th>CONTENT</th>
<th>Page</th>
</tr>
</thead>
<tbody>
<tr>
<td>EXECUTIVE SUMMARY</td>
<td>4</td>
</tr>
<tr>
<td>CURRENT STATUS OF SWISS DOMESTIC BANKING</td>
<td>6</td>
</tr>
<tr>
<td>FUTURE CHALLENGES</td>
<td>16</td>
</tr>
<tr>
<td>THE WAY FORWARD</td>
<td>20</td>
</tr>
<tr>
<td>CONCLUSION AND NEXT STEPS</td>
<td>30</td>
</tr>
</tbody>
</table>
Swiss domestic banks, namely the Swiss units of UBS and Credit Suisse, Kantonalbanken, Raiffeisenbanken, regional banks and other retail-focused banks have managed to maintain their profitability in a challenging negative interest rate environment. They reported aggregated equity returns of 5.7% in 2016. When adjusted for the overcapitalization of these banks, this still translates into a small positive economic profit after accounting for capital costs.

Even shocks such as negative interest rates, increasing capital and liquidity requirements, and decreasing loan growth rates did not have a significant negative impact on the overall profitability of the Swiss domestic banking market in the period from 2011 to 2016.

However, we do see several underlying weaknesses in the current position, as follows:

- Valuations have continuously declined for quoted domestic banks, indicating that investors are no longer willing to pay a premium for banks with the existing business model.
- Near-stable interest rate revenue has been achieved only through a substantial balance sheet expansion, and sometimes through increasing risk related to Asset Liability Management (ALM). These factors compensate for declining interest rate margins.
- Structural costs have increased in a progressively more digitalised world.
- The business model and cost structure rely on significant loan growth in excess of expected nominal GDP growth.

Moreover, we anticipate a number of future challenges which might exert a negative impact on the Swiss domestic market. Banks must get ready to tackle the challenges below:

- New players in the core mortgage business with a better refinancing position and therefore a significant cost advantage (such as insurance companies or pension funds)
- Transformation of the traditional client interaction channels, such as through a Swiss equivalent to the Second Payment Service Directive (PSD2)
- High investment and maintenance costs to achieve cutting-edge customer experience in the digital area
- Possible risk of Fintech competition, especially by foreign players which can transfer their European or Global solutions to Switzerland with a scale advantage

In light of these dynamics, Swiss domestic banks need to reinforce tactical optimization levers within the existing business model through a forceful defence and strengthening of the interest rate business.

They should also look to expand in potential growth areas such as wealth management, insurance and the small and medium-sized enterprises (SME) arena, while also capturing opportunities in asset management and trading. Cost mutualization can help in reducing costs more than a simple focus on traditional cost management initiatives can do.
In the long term, banks need to develop a new strategic digital target operating model with a focus not only on digital client interaction, but also on rigorous process standardization and automation. For most banks, an incremental approach with continuous improvements in this future state is most suitable.

Almost all the levers require data, analytics and technology geared approaches. Banks have to aggressively invest and expand capabilities to position themselves accordingly.

Swiss domestic banks are well positioned to meet these challenges. Given today’s cost position and profitability, they can mitigate existing weaknesses and risks to their business model, and continue to deliver an economic profit for their owners.

SCOPE OF REPORT

This analysis includes Swiss banks focusing on the domestic market (retail banking, SME banking and Swiss onshore wealth management). The sample used as Swiss domestic retail banks in this study was limited to UBS Switzerland, Credit Suisse Swiss Universal Bank (SUB), Raiffeisen Group, all cantonal banks, PostFinance, Bank Cler/Bank Coop, Migros Bank and Valiant. For some analysis, we used individualized data of regional banks and individual Raiffeisenbanken as well. The sample was restricted further due to non-availability of historic data. This was particularly the case for the domestic activities of UBS and Credit Suisse, so that a long-term comparison would have been unreliable. Due to differences in taxation regime (especially with cantonal banks) and previous tax credits, return on equity levels of different banks cannot be compared one-to-one. Income statement and balance sheet items have been standardized and grouped, for all banks. However there might still be inconsistencies due to different definitions of reporting categories. Comparisons with international peers rely on a comparable sample of banks in these countries and can be distorted by local regulation, taxation levels as well as local market conditions.

1 Excluding UBS Switzerland and Credit Suisse SUB
CURRENT STATUS OF SWISS DOMESTIC BANKING
Swiss domestic banking (retail banking, SME banking and Swiss onshore wealth management) is in good shape. Banks have managed to maintain their profitability, reporting aggregated gross operating profit margins of 42.3% in 2016, and equity returns of 5.7%. Adjusted for overcapitalisation, returns on risk-adjusted capital were 7.8%. In other words, given their stable business model and the low interest rate environment, the average domestic bank delivers a small economic profit on its equity.

Both return on equity and return on risk-adjusted capital are almost exactly at the same level seen in 2011, adjusted for the decreasing market interest rate. This is a substantial achievement. In the intervening period, banks have had to confront several shocks, in particular the negative interest rate environment, but also increased capital and liquidity requirements, and growing regulatory costs.

Exhibit 1: Gross operating profit margin, return on equity, and return on risk-adjusted capital in percentage terms, aggregated Swiss domestic banks excluding UBS/CS and, for 2016, including the domestic business of UBS/CS (in %)

Source: Company annual reports, Orbis, Oliver Wyman analysis
Especially compared to their domestic peers in Germany and Southern Europe, Swiss banks are in a very good position. Only banks from the Nordics achieve better gross operating profit margins, in much more concentrated markets.

When comparing gross operating margins, there are significant differences between the various European markets. The Nordics have seen very high profitability increases over the last years, while other markets are struggling with lower profitability rates.

The Nordic banks have achieved these growth rates through all-encompassing transformation processes in their business and operating models, involving automation and standardization, coupled with substantial cost-saving initiatives.

However, it is not possible to apply insights from one country to another without taking into account the specific local situation, given the variation in customer behavior, level of competition and the relative economic situation of each market.

Exhibit 2: International comparison of gross operating profitability of domestic banks (in %)

Source: Company annual reports, Orbis, Oliver Wyman analysis

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* Based on samples of domestic-oriented banks for the respective countries, Switzerland without UBS Switzerland and Credit Suisse SUB
However, we have identified a number of structural weaknesses in the current business model of many banks, and this is to some extent reflected in the stock market valuations.

Valuations for quoted Swiss domestic banks have eroded during recent years. Between 2007 and 2016, these banks saw a decline in price-to-book ratio (P/B) of approximately 25%, to a value of 1.3, with about one quarter of all Swiss domestic banks having a P/B ratio of below 1. This indicates that investors are no longer willing to pay a premium for banks with the existing business model. This development is less visible in nominal stock prices, since banks retained on average 50–60% of their profit in a move to increase their capital cushion and to fund their growing balance sheets.

The single greatest determinant of stock price is the gross operating profit margin, which explains around 20% of P/B ratio variation. Investors are willing to pay a premium for retail banks operating with a low cost/income ratio and a high return on equity, and are also willing to pay for larger size. Other aspects like business growth, sources of income or dividend policy have no significant impact on valuation.

Between 2011 and 2016, both the revenue and the cost structure of Swiss domestic retail banks remained quite stable. Total revenues for 2016 were, in nominal terms, slightly higher than they were in 2011, with a small increase in trading net income and other income. Costs saw a larger, but still moderate, increase of approximately 2% a year.

However, this apparent stability masks a structural weakening of the underlying business model, mirroring the decline in stock market valuation.

Exhibit 3: Price-to-book (P/B) ratio, aggregated Swiss retail banks

![Graph of Price-to-Book Ratio](chart)

Source: Datastream, Oliver Wyman analysis

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*Sample: Listed Swiss retail banks, 2007–2016*
On the revenue side, the most relevant structural weakness is the high dependency on interest income, on which all Swiss retail banks rely. In our sample, 55% of total operating revenue consists of interest revenue. In the case of smaller cantonal banks, regional banks and Raiffeisen banks, this figure can be as high as 80%.

Net interest revenue has stagnated at 0.2% growth per annum between 2011 and 2016. This was achieved by a significant structural balance sheet expansion, mainly driven by a growth in mortgages (about 4.5% per annum between 2011 and 2016) to compensate for declining interest margins. A deep dive at selected banks also shows an increase in interest rate risks and a reliance on return from maturity transformation. Revenues have been kept stable, but at the cost of substantially larger balance sheets and associated risks, i.e. interest rate risks, credit risks, liquidity risks.

Exhibit 4: Operating revenue and costs, aggregated Swiss domestic banks\(^\text{10}\) (in %)

<table>
<thead>
<tr>
<th>Year</th>
<th>Fee and commission net income</th>
<th>Trading net income</th>
<th>Other income</th>
<th>Net interest income</th>
<th>General administration</th>
<th>Personnel expenditure</th>
</tr>
</thead>
<tbody>
<tr>
<td>2016</td>
<td>0.2</td>
<td>1.2</td>
<td>3.8</td>
<td>22</td>
<td>1.3</td>
<td>11’-16(^\text{10}) change p.a.</td>
</tr>
<tr>
<td>2016</td>
<td>2.1</td>
<td>2.4</td>
<td></td>
<td></td>
<td></td>
<td>2.2</td>
</tr>
</tbody>
</table>

\(^{10}\) Aggregated domestic banks for 2016, including results for UBS Switzerland and Credit Suisse SUB. Historical comparison (annual change 2011-2016) excluding UBS Switzerland and Credit Suisse SUB.

Source: Company annual reports, Oliver Wyman analysis
In the given environment of low or negative interest rates, in combination with intensifying competition in the mortgage market due to the structural cost advantage of pension funds and insurance companies, we expect this trend to continue and even become more pressing for those banks with a high reliance on interest income. Business models centered on the balance sheet have a limited appeal in the short term.

If we look closely at individual companies, diversified banks appear more resilient than specialized players. For example, the introduction of the negative interest rate regime by the Swiss National Bank in December 201511 affected various client segments differently. Margins on all credit products increased, while deposit products now largely result in a negative margin. Well-diversified banks therefore enjoy a natural hedge in their business activities. The banks that are most tested by negative interest rates are those which concentrate their activities on a very specific business model, such as a focus on deposit gathering.

The second pillar of revenue – fee income – grew a little more, with 1.2% growth per annum between 2011 and 2016, thanks to growing assets under management only partially offset by declining margins. However, since most fee volume has no direct connection to the balance sheet, and requires just very little capital, the decreasing margins in fee income do not have the same impact on equity returns as the interest margin business does.

The strong increase in trading income of 3.8% per annum mainly derives from the activities of certain banks, and is limited in scale. Especially for banks with sufficient scale, a healthy credit rating and a strong client base with corporate and institutional clients, such activities can be very profitable in the current environment and offer an attractive revenue diversification opportunity.

11 The Swiss National Bank introduced negative interest rates of -0.25% (middle of target band) on December 18th, 2014, effective January 22, 2015. On January 15, 2015, it announced a further decrease to -0.75%
On the cost side, both personnel expenditure as well as general and administrative expenses continue to place pressure on retail banks. The total increase in personnel costs at retail banks (excluding UBS and Credit Suisse) amounted to 2.1% annually between 2011 and 2016, well above general inflation. There are two drivers for this increase – a growth in the number of employees, and personnel factor costs.

Firstly, the number of full-time equivalent (FTE) employees increased by 0.4% annually. Secondly, factor costs increased. The personnel costs per FTE increased by 1.7% annually, well above the average Swiss wage growth of 0.7%.

Increasing personnel factor costs are not uncommon in European banking since banks use less low-qualified resources in transaction-oriented front-office, mid-office and back-office processes, while hiring better qualified employees to manage more complex processes.

However, this usually leads to a reduction in employment, around 1% a year in domestic banking in markets like Germany and Southern Europe over this time period. This is not the case in Swiss retail banking. Swiss retail banks keep employment stable, while increasing costs per unit.

This can be explained by Swiss banks still offering a large branch network, resulting in significant costs. Other European markets such as the Nordics and Benelux achieve a high level of service with far fewer branches. Denmark is one of the markets where banks have drastically cut back their bank network in order to save costs and overhaul their distribution channels.

Exhibit 6: Impact of negative interest rates on business lines, Swiss domestic banks
Structural factor cost increase 5.3 \% 2011-2016

Average Swiss wage increase 3.4\% 2011-2016

Indexed FTE / Personnel expenditure (2011=100)

Personnel expenditure
FTE

Exhibit 7: Number of FTE and personnel expenditure, aggregated Swiss domestic banks excluding UBS and CS\(^{12}\); commercial bank branches per capita, European markets

Source: Company annual reports, BFS, OECD, ECB, Oliver Wyman analysis

\(^{12}\) Large payments to sustain banks’ employee pension funds occurred in 2012 (ZKB, Raiffeisen), 2015 (Berner Kantonalbank) and 2016 (ZKB). Adjusted for these one-off payments, the structural factor cost increase was at 3.8\% between 2011 and 2016
Lastly, we see many banks with established business models which rely on significant loan growth far in excess of expected nominal GDP growth. For the most part, Swiss domestic banks still expect to grow their loan book faster than longer-term nominal GDP growth rates, and have set up their structures accordingly. We believe that these banks need to adjust their business model to a "Low Loan Growth Era": The annual growth rate of outstanding mortgages has been continually decreasing over recent years, and this trend appears unlikely to change.

Overall, Swiss retail banks have managed to achieve stable results in a challenging market environment. However, it will become more difficult for the banks to maintain their performance, given a number of structural weaknesses such as a high dependency on declining and structurally unattractive interest revenue pools, structural increases on the cost side, and a mind-set that is determined to grow balance sheets above the long-term market potential. Early warning signs can already be seen in the form of decreasing valuations.
FUTURE CHALLENGES

In addition to the structural weaknesses highlighted above, we see a number of future challenges with the potential to place much greater pressures on the Swiss domestic banking businesses.

First, new players are emerging in the core mortgage business and also in the SME loans market. These players, such as insurance companies or pension funds, have structural advantages as they do not need to compensate for deposit rates stuck at zero, and for rising capital costs.

Currently, banks are cross-subsidizing lossmaking deposits by repricing the asset side, mainly within the mortgage market. All Swiss domestic banks have a similar funding structure, dominated by deposits. At the same time, these banks dominate the Swiss mortgage market with a combined market share of about 95%, and there is almost no corporate lending by non-banks to SMEs. It was therefore possible to reprice loans and compensate for negative margins on deposits through a margin increase on mortgages and other loans. But now other players have entered the market, able to offer more competitive mortgage rates, mainly for longer durations and in low-risk and less complicated mortgage structures.

Even though non-banks still only hold about 5% of the Swiss mortgage market, an interest rate advantage coupled with a capital advantage as well as new distribution models could significantly increase competition from non-banks, potentially resulting in significant margin pressure for banks.
In the Dutch mortgage market, banks have lost market share to competitors over recent years. Since 2010, the share of mortgages held by banks has reduced slightly, from 80% to 76%. However, for new mortgages only, a much larger share is now issued by non-banks (38%). Of all players, pension funds have the most capacity to continue expanding their investments in the mortgage markets, with mortgages currently only representing 2% of their investment portfolio.

A second challenge is the transformation of traditional client interaction channels. When it comes into effect in the European Union (EU) in January 2018, the revised Payment Services Directive (PSD2) has the potential to alter traditional market rules.

PSD2 will create the legal foundation for full openness of customer and product data across all providers of financial services in the EU. Data related to deposits, payments, loans, and investments will be available to any firm that wishes to provide related services, irrespective of which firm holds the customer account. PSD2 is likely to accelerate the rise of non-bank aggregators and platforms that provide a single view of all customer accounts across financial institutions.

As a result, the personal financial management and data layers which have been such important tools in banks’ armory will be placed into the hands of third parties that are not concerned with who provides the underlying products. These independent providers will have incentives to obtain the best deal for their customers by providing price transparency and facilitating hassle-free switching. In this scenario, many incumbents may well be relegated to the role of pure product suppliers. They will be subject to fierce price competition, with limited control of the customer experience, but could nevertheless remain hampered by existing risk and capital requirements.

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**Exhibit 9: Competition from Non-banks**

Case study on the Dutch mortgage market\(^{13}\) (in %)

<table>
<thead>
<tr>
<th>Year</th>
<th>Banks</th>
<th>Non-Banks</th>
</tr>
</thead>
<tbody>
<tr>
<td>2010</td>
<td>20</td>
<td>80</td>
</tr>
<tr>
<td>2015</td>
<td>25</td>
<td>75</td>
</tr>
<tr>
<td>New mortgages (H1 2016)</td>
<td>38</td>
<td>62</td>
</tr>
</tbody>
</table>

Source: DNB

\(^{13}\) DNB
At the moment, it is still unclear how and when Swiss regulation or the market will react to PSD2. However, it does seem highly likely that Switzerland will put in place regulation that is similar to PSD2, or that the market will push for similar outcomes. It will also be possible to use technology to substitute, at least to some extent, for the lack of a PSD2 API (Application Program Interface).

A third and final challenge centers on the high investment costs necessary to achieve cutting-edge customer experience in the digital area. Swiss banks invest heavily in new client-end digitalization projects, either through proprietary or third-party solutions. The main current initiatives in the market entail the improvement of traditional e-banking and mobile-banking solutions, product-oriented solutions (mainly online mortgages), digital client onboarding, and a shift to a more life-event and client-centric advice process supported by technology. Most of these initiatives have not succeeded in generating a broader market impact, but are nevertheless necessary in adapting to a long-term shift in client demands.

The direct project costs of these initiatives can be significant, especially given that traditional core banking systems are not well suited to short-term innovation. However, the true long-term costs are less visible. Currently, almost all these initiatives are set up on traditional process layers, and therefore add cost and complexity to existing processes. Especially if the core processes are neither digitalized nor standardized, a new online channel can lead to much higher total costs per process unit than traditional channels. There are several players in Switzerland where a digital mortgage loan request induces far higher per unit costs than a traditional paper-based loan request.

At the beginning of a digital transformation, this state of affairs is perhaps inevitable. But it does lead to increasing structural costs throughout the organization which cannot be justified by the often meagre impact on revenue from a new digital initiative.

The challenges emerging from new competition in the core business, significant regulatory changes and the high investment costs of moving to a digital world can all potentially damage banks if they are not properly handled. It will be crucial for banks to prepare and organize themselves for these challenges.

**Exhibit 10: Illustration of additional cost layer to enhance customer experience**
THE WAY FORWARD
Structural weaknesses in the business model coupled with the challenges outlined above demand three principal levels of responses: short-term, mid-term and long-term (see Figure 11).

Banks can use a number of short-term tactical optimization levers within the existing business model to protect their current income stream and level of profitability, especially in the interest rate business.

Alternative revenue streams in non-interest related services, and improvements in cost structures, can serve as more structural levers to protect and expand profits in the medium term on a more sustainable basis.

For the long term, banks need to transform their business and operations more fundamentally towards a ‘Digital Target Operating Model’, building on structural enhancements.

All three elements are interlinked and can support each other.

Exhibit 11: Measures to improve performance

<table>
<thead>
<tr>
<th>HORIZON OF OPTIMIZATION</th>
<th>MEASURES</th>
</tr>
</thead>
<tbody>
<tr>
<td>long-term</td>
<td>Digital Target Operating Model</td>
</tr>
<tr>
<td></td>
<td>• Develop sustainable operating model</td>
</tr>
<tr>
<td>mid-term</td>
<td>Structural levers</td>
</tr>
<tr>
<td></td>
<td>• Win additional non-interest related revenue</td>
</tr>
<tr>
<td></td>
<td>• Increase cost position by cost mutualization</td>
</tr>
<tr>
<td>short-term</td>
<td>Tactical levers</td>
</tr>
<tr>
<td></td>
<td>• Protect client interest income</td>
</tr>
<tr>
<td></td>
<td>• Improve ALM &amp; balance sheet management</td>
</tr>
</tbody>
</table>

< 2 years < 5 years > 5 years
SHORT-TERM OPTIMIZATION – TACTICAL LEVERS

Given the current dependence of Swiss retail banks on interest margin business, the number one priority short-term objective should be the protection of this income stream, using client-oriented and balance sheet-oriented (ALM) measures.

Protection of interest income from clients:
We propose the aggressive reduction of the current cross-subsidization of deposits by loans. Current cross-subsidization does lead to strategic risks, since it both encourages competitors such as pension funds and insurance companies to increase their activities in the credit market, and also stimulates the development of an alternative credit infrastructure. Even if the interest rate environment changes, these competitors will continue to place pressure on margins.

Possible protective measures to reduce this cross-subsidization are:

• Passing on negative interest rates, wherever possible, on both a customer segment and client level, by using advanced analytics and customer segmentation instruments (deposit characterization and management)
• Offering additional client value by using retail packages, especially in combination with new digital advice models, with a focus on clear client value
• Increasing discipline in price setting for clients, both for deposits and credit, by using advanced analytics
• Systematically using an individual client view in managing profitability, and attempting to avoid loss-making client relationships, calculated at marginal costs

Improve ALM and balance sheet management:
In addition to client-centric measures, we suggest additional steps, relating to the management of the total balance sheet (ALM). These steps are often easier and faster to implement than client-oriented measures but work best in parallel.

Typical actions involve:

• Limited shift to cheaper, capital market-driven methods of funding
• Reclassification of deposits, use of alternative replicating portfolios
• Adjusting risk appetite in interest rate risk exposure to the level of equity
• Moving towards a benchmark strategy in ALM risk management
MID-TERM OPTIMIZATION – STRUCTURAL LEVERS

We see the potential to improve the profitability of retail banks in the medium term. From our perspective, they should primarily focus on additional revenue potential, rather than pure cost reductions. Cost reductions should be a by-product of a more fundamental transformation towards a digital target operating model (see below).

Additional Revenue:
Swiss domestic banks have been trying to capture additional revenue sources for years, both at an individual company and industry level. Most initiatives have focused on wealth management, asset management, and SME business. Despite some successful examples for individual companies, these initiatives could not be translated into significant additional revenue on an industry level. However, we do see opportunities for renewed initiatives in similar areas, but using a more technology-driven or solution-driven approach:

• **Wealth management/affluent banking:**
  This is by far the most tempting segment, especially for banks with a strong foundation in the mortgage area. However, given regulatory challenges and the trend of declining margins in this market, it will not be easy to develop a profitable wealth management franchise, especially using an advisor-centered approach. We suggest a very technology-driven approach in which most of the day-to-day customer experience is delivered in a mass-customized, automated way. We also propose the integration of the distribution of wealth management products in existing advisory processes, especially the mortgage advisory process.

• **Insurance business:**
  Banks offer various types of insurance, especially life products. However, the hopes of turning this class of business into a significant source of revenue have often been disappointed. Given the weakness of demand in the life insurance market, and the inexperience of the distribution channel in selling non-life products, we would suggest a more solution-based approach. This would involve selling insurance packages, for example housing-related products, which can be integrated seamlessly into existing sales processes such as mortgages. An alternative approach is to integrate insurance products into banking packages. Banks typically have a closer relationship with their clients than insurance companies and are therefore well positioned to capture additional revenue.

• **SME business:**
  For banks with a small footprint in the market for small and medium-sized business, this is a potential growth area as entrepreneurs can be approached by using the retail and affluent banking franchise. The SME market is itself divided into two: a domestic-oriented and an international-oriented market. The international-oriented market has a much higher revenue per client. However, entering this more attractive market involves a significant investment in expertise and technology (trade finance, foreign exchange, derivatives and advice capabilities) that is very difficult to realize without a critical mass of customers.

• **Trading and asset management:**
  These services have traditionally not been a priority for managers of retail banks. However, they offer significant growth potential with limited cost of capital. Given the high rating of many Swiss banks, they offer very attractive counterparties and therefore the opportunity to build up similarly attractive franchises in trading. In asset management, the minimum size required to operate many products has decreased significantly over the past years. It is therefore possible to offer bank-labelled funds to existing and new clients, and make this business profitable at limited costs. Such a push could support a move into the wealth management / asset management field in particular.
Cost optimizations:
To confront structural cost increases, banks can use mitigation measures such as personnel factor cost management, general organizational efficiency programs, automation and the standardization of existing processes. However, given past experience, this kind of cost optimization is more a continuous process to keep profitability levels stable, but is unlikely to lead to long-term structural cost advantages in relation to peers. Moreover, many potential cost levers (such as the optimization of the branch network) are well known to the banks but often difficult to execute, given the specific ownership structure of many retail banks.

We suggest more focus on cost optimization in association with other banks through cost mutualization. The Swiss domestic banking industry has a good track record in establishing and managing these kinds of ventures, over the past years, there were even radical discussions in the market to develop new models (for example, the “Transaktionsbank”/“Superbank” initiative). We also suggest that they implement growth initiatives or additional services together, thereby reducing additional costs for all participants.

Governance issues constitute the main challenge for these initiatives, in terms of both their setup and management, especially if the delivered services cover areas which can be sources of strategic advantage. Furthermore, in fast-changing markets, the venture will possibly have to compete with some of its shareholders to be economically viable, leading to structural pressure in these organizations. As an alternative, and possibly as the first step to a partnership, common industry standards both on a process and technical level can be established, and then used by the whole industry. This will enable a high level of interoperability of employees, IT and third-party suppliers, and facilitate economies of scale for the whole industry, while maintaining the maximum possible level of flexibility.

Cost Mutualization – joining forces to concentrate on core business
Case study on the Swedish market – Bankomat AB and Tambur

Banks in Sweden have joined forces to make their processes more efficient and substantially reduce costs through cost mutualization in non-core areas:

1. Shared ATM network:
Bankomat AB is the sole owner and provider of ATM machines in Sweden. It was founded in 2010, and is jointly owned by the five largest banks in Sweden. The purpose of founding Bankomat AB was to set up a simple shared infrastructure between the banks for ATMs and cash deposit machines. In 2013, it took over all the 2,200 ATM machines in the country. Since then, it has offered services to all card issuers, either as a customer of the company or via the VISA and MasterCard networks.

2. Joint mortgage documentation system: Tambur is a joint initiative of Swedish banks to digitalize the mortgage documentation process in retail banking. Historically, the mortgage documentation process has been fairly manual, with documents passing back and forth many times. In 2015, most of the banks in Sweden agreed to create an IT portal, Tambur, which acts as a centralized documentation filing system, containing all the documentation and logging the processes.
LONG-TERM OPTIMIZATION – DIGITAL TARGET OPERATING MODEL

The above measures will not suffice in the long run, especially since offering great client value in the digital space without more fundamental transformation can have a potentially negative impact on the cost structure. Banks should avoid purely adding a digital layer of cost, or organizational complexity, for an extended period of time.

While many Swiss domestic banks have heavily invested in online client interfaces, they still lack end-to-end automation and standardization in their core operating processes (such as mortgage or lending processes). In order to break the increasing structural costs of recent years, which are partly due to the high investment in IT and client interfaces, banks also need to invest in automating processes. This is where genuine savings potential lies.

To achieve that, banks need to define a digital target operating model and to implement it throughout the organization. If done so, the cost savings associated with digitalization will have a significant impact on bank costs, and will compensate for increasing expenditure on their client interface.

Exhibit 12: Illustration of a Digital Target Operating Model (D-TOM), simplified
In our experience, a successful Digital Target Operating Model has the following characteristics:

- A proprietary omnichannel client interface which allows the client and the front-office to communicate seamlessly with each other at all times. Both front office and clients work on the same platform and have, as a general rule, access to the same information and insights.

- An insight generator which uses data pools, and turns data into personalized, actionable and automated insights for clients. Again, both front office and the client have access to the same insights. The generator can use third-party engines to generate superior insights.

- A centralized data pool which combines client data, transaction data and third-party data, and acts as a data source for the insight generator on which client services rely. This database comprises current customer relationship management (CRM) databases, such as data on potential clients. It should be flexible enough to include new data sources in a fast and cost-efficient way.

- Highly automated and standardized core processes of the back office and middle office functions. These processes should be started and completed without any additional interaction with the client or the front office, even if the processes mainly consist of manual and/or individualized components. It should be possible to outsource any given process to a third party. Processes should be modelled very much like monoliners (companies organized around a single product or even process), with a minimal level of complexity. For example, processes in the core mortgage credit process should be highly automated with an instant legally binding contract available for the front office, and should possibly even involve third parties in an instant bidding process (open architecture). Such processes are not possible in the current systems.

- A core database which holds all transactional data and all other data. This needs to be of extremely high quality (such as know your customer (KYC) and compliance data). This database does not need to be flexible.

Given the complexity of existing IT architecture, successfully developing a digital target operating model will be a long-term undertaking. It is quite common for banks with a proprietary core banking system to have four or more coding languages and systems that were developed in the 1980s or even as far back as the 1970s. Banks which use a third-party core banking system (mainly Avaloq and Finnova in Swiss retail banking) also typically have a high level of customization, and still have several other peripheral systems in place.

Modernizing existing software and IT architecture is a challenging task. We believe that, after defining the long-term strategic target, it is imperative to focus all efforts in achieving it.

There are two levers to use for reaching this long-term strategic ideal. One is to focus on the client side and seek to improve customer experience. The other is to focus on core processes, and seek to strengthen the underlying fundamentals of the business.

The easier method, at least in the short term, is to focus solely on client experience. The ideal result would be a quick improvement in customer experience and a direct positive impact on revenue. The worst possible outcome is a large collection of apps and client interfaces that are rarely used by clients, are not integrated with the core banking system and lead to significant IT risk and costs. To be successful, some standards and a medium-term plan to integrate these solutions into the core process should both be in place.
A more ambitious approach is to design a new end-to-end process, with or without client interaction. In effect, this would be equivalent to launching a new monoliner or replacing an entire process. Such a procedure can be extremely effective if carried out in an entrepreneurial spirit with limited resources (see examples below). More process-focused methods involve changing parts of the core processes by using a process redesign, or even modernizing or replacing a core banking system.

A very interesting approach for large banks is to set up an entirely new, modern bank (including both front end and back end) from scratch. This is a solution contemplated by several international banks. However, due to the upfront costs of such an endeavor and the need to run two entities in parallel for some time, this is likely not to be feasible for almost all Swiss banks.

Exhibit 13: Ways to proceed to digitalize a bank’s operating model

Exhibit 13: Ways to proceed to digitalize a bank’s operating model

End-to-End Lending Process Automation
Case studies: Disguised client examples

Onboarding process:
A clearly structured account opening and onboarding process for retail clients can increase operational efficiency and effectiveness. After a rigorous redesign and automation of the onboarding process, a European retail bank managed to achieve more than 50% time savings and 30-60% cost savings when compared to its traditional processes. Client satisfaction, measured by Net Promoter Score (NPS), also increased by 30% on average.

Lending process:
A fully automated lending process substantially reduces the lending decision lead times for clients. Another European retail bank managed to redesign and fully automate their SME lending approval process to take less than 24 hours for clients (compared to 7-14 days before the redesigning of the process) while the disbursement is made after 5-7 days (compared to 5-20 days in the traditional process).
ING completely re-engineered their banking business to meet digital market needs. A single target operating model was launched across all countries. The entire organization adopted an agile way of working, with multidisciplinary teams responsible for end-to-end processes in order to respond more quickly to customer feedback.

**Client interface:**
A one-bank experience with seamless client interaction, standardized products, contracts and documentation. An omnichannel banking model delivers distinctive customer experience across all channels. The branch network is retained only for complex services.

**Insight generator:**
An initiative focusing on analysis of client behavior by establishing a new Advanced Data Analytics team, mandated to develop data analytics products to enhance ING client-oriented activities.

**Core processes and database:**
Substantial investment in IT to further automate and standardize routine processes.

The resulting impact was substantial:

- **100%**
  digitalization of daily activities

- **700**
  client processes completely re-engineered

- **> 1.000**
  different systems reduced to **100**

- **270 Mio. Euro**
  annual cost savings by 2017

- **> 95%**
  customer interaction via remote channels

- **1**
  target operating model rolled out across all countries
CONCLUSION AND NEXT STEPS
Swiss domestic retail banks are still in good shape. Despite the many challenges they have confronted in recent years, such as negative interest rates, increased capital and liquidity requirements or increasing regulatory costs, they have managed to record a solid performance.

OUR FUTURE VIEW – SWISS RETAIL BANKING REVENUES BY 2022

If retail banks manage to stay relevant for their clients, we see the potential for a growth in revenue in line with the level of expected nominal Swiss GDP growth (2% p.a.). We believe that net interest revenue will continue to grow below GDP, even if interest rates increase again. We do not think that the level of competition in the mortgage and deposit markets will lead to shrinking margins.

However, we think that fee income can be increased in line with nominal GDP, if banks manage to offer a client-focused, client-centric offering. In trading and other capital market-oriented offerings, we see a significant growth potential at about twice the level of GDP growth. Given the underlying increase in importance of most capital market products, Swiss retail banks are well positioned to increase revenues in this area. An unknown element is the additional revenue potential from insurances. As discussed, we see potential for retail banks, especially in the non-life segment. This could likely become a significant driver of additional revenue. This will depend on banks finding ways to integrate insurance products into their solution packages and offering these to their clients in a seamless and cost-efficient way.

Exhibit 14: Future view, expected operating revenue 2022 (in %)

<table>
<thead>
<tr>
<th></th>
<th>2016</th>
<th>2022</th>
</tr>
</thead>
<tbody>
<tr>
<td>Net interest</td>
<td>55</td>
<td>50</td>
</tr>
<tr>
<td>Trading net</td>
<td>31</td>
<td>30</td>
</tr>
<tr>
<td>Other income²</td>
<td>1.2</td>
<td>1.2</td>
</tr>
<tr>
<td>Trading net</td>
<td>2.0</td>
<td>2.0</td>
</tr>
<tr>
<td>Other income²</td>
<td>3.8</td>
<td>3.8</td>
</tr>
<tr>
<td>Trading net</td>
<td>5.0</td>
<td>5.0</td>
</tr>
<tr>
<td>Other income²</td>
<td>22</td>
<td>22</td>
</tr>
<tr>
<td>Trading net</td>
<td>5.0</td>
<td>5.0</td>
</tr>
</tbody>
</table>

1. Change p.a. 2011-2016 excluding UBS Switzerland, Credit Suisse SUB.
2. Includes dividends of investments as well as divestments.
Source: Company annual reports, Insurance Market Report FINMA, Oliver Wyman analysis.
Although we believe that Swiss banks can maintain this success, they also need to be wary of complacency. They should pay attention to warning signs in the market and take action now to prepare for such eventualities. Such indications include declining valuations, suggesting that markets are unwilling to pay a premium for their business model anymore; a dangerously high dependency on interest revenue in an environment with negative interest rates; structurally increasing costs, especially in relation to personnel expenditure; and a mindset that still expects growth rates in the main credit products above the level of GDP growth.

Banks also need to be prepared for new players entering the market, and substantial regulatory changes that will certainly affect current industry structures.

In the short term, banks should forcefully defend their existing interest rate business. To counter the threat of market entrants, they should reduce cross-subsidization of deposits by loans, and look to capture additional revenue potential through pricing and ALM measures.

In the medium term, we propose a focus on capturing additional revenue pools which are independent of the interest rate business. While being challenging, we believe that most players should be able to increase revenues through wealth management, insurance business, SME business, asset management and trading income. Cost reduction initiatives need to be performed, but are unlikely to be a source of a long-term sustainable advantage. However, cost mutualization initiatives, especially when responsible for new revenue, could be carried out more vigorously.

In the long term, banks need to manage a transformation towards a fully digitalized Target Operating Model. This not only involves investing in a digital client interface – which many banks have already done – but also implementing a rigorous automation and digitalization of core processes in the back office and middle office. Such actions will ensure that organizations remain sufficiently agile, innovative and flexible. In this way, they can become more effective, efficient and, most importantly, can develop much leaner cost structures in readying themselves for the challenges ahead.

Almost all the levers require data, analytics and technology geared approaches. Banks have to aggressively invest and expand capabilities to position themselves accordingly.

Swiss domestic banks are well positioned to meet these challenges. Given today’s cost position and profitability, they can mitigate existing weaknesses and risks to their business model, and continue to deliver an economic profit for their owners.
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