

# the journal

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August 2003

Tackling the key issues in banking and capital markets





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# Editor's comments

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by Phil Rivett



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Welcome to the third edition of the PricewaterhouseCoopers banking and capital markets journal. In a testing market and regulatory environment organisations continue to focus on the bottom line – transforming operating models, rationalising costs and outsourcing operations, all the while ensuring that the robustness of the control environment is not undermined. In this issue we explore some of the approaches being taken, and look at some of the developments in other areas of the industry.

Cutting costs and streamlining operating models to get the best value out of internal processes is putting the question of outsourcing high on the agenda for many organisations. In their article ‘New – and non-traditional – survival strategies for financial services firms’, Peter Miscovich, Ron Collard and Andy Miller discuss the development of outsourcing strategies, and how they can be combined with workplace transformation opportunities to cut costs, focus on core operations and obtain real competitive advantage.

Operational resilience and risk and control transparency are critical when entrusting third parties with key roles in supporting an organisation’s operations. This is increasingly being recognised by industry regulators and market practice.

In ‘Market transparency’, Sam Dibb, Chris Thompson and John Parkhouse explore the developments driving the focus on these issues, the forms of control assurance that are becoming more commonplace and the opportunities for those that embrace transparency in this area.

Customer relationship management is a frequently used, often misunderstood, term. While the concept has yet to provide the returns promised since its development in the mid-1990s, the ongoing quest for organic growth keeps it firmly on the agenda. In ‘Customer Relationship Management: transforming the retail banking industry’ Andy Elliott and Michelle McLaughlin explore some of the current views and experiences within the industry, why the concept is still important and the risks inherent in implementing it.

Adding to the woes of poor returns from the equity markets, private banks and wealth managers in traditional markets are being challenged by increasingly demanding clients, by more regulation and by competition from firms in the ‘new’ markets. In ‘Wealth management – a new world order?’ Johannes Grosskopf, David Newton and Salman Ahmed describe how organisations are reacting to these pressures and what options are available to firms determined to succeed.

The expansion of the European Union will bring untold opportunities for the banking industries in Central and Eastern Europe; however, many of these are in relatively early stages of development, and may not be able to compete successfully in the new European marketplace. In ‘Central and Eastern European Banking: European Union accession and other issues’, Jim Kernan, Alper Onder and Tam Basunia look at what this means in practice for those banks in the first wave of accession countries and those in other countries in the region.

In an increasingly competitive global credit card market, there remain significant differences across Europe in the way that people use credit cards, or indeed whether they choose to use them at all. In ‘Changing the European credit card landscape – A challenge too far?’ Patrick Atkinson, Jens Roennberg and Jose Wahnón look at the differing attitudes to credit across Europe.

I hope you enjoy the banking and capital markets journal and that the articles continue to provide thought-provoking insights into the key issues facing the industry. As always we would appreciate your feedback and comments as well as any thoughts and suggestions on the subjects that matter to you.

# New – and non-traditional – survival strategies for financial services firms

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by Peter J. Miscovich, Ron Collard and Andy Miller



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Global financial services organisations are being forced to streamline, cut costs and improve operational efficiency yet again while maintaining or improving customer service, and they must take these measures today if they are to survive in the increasingly competitive global economy.

What's going on? The growing complexity of globalisation, increasing government regulation both at home and abroad, decreasing customer loyalty, slower or non-existent growth and socio-political and economic volatility have placed global financial services companies under unparalleled pressure on many fronts, including:

- Over-capacity and the need to become even more fiercely competitive in the future as the industry continues to consolidate.
- Many back office systems and operations so old and decrepit that they are close to failing entirely, a particular danger for equity trades. Replacement will cost millions of dollars at a time when most firms are cutting costs.

- The priority of operational cost reduction to achieve continually lower operating expense ratios.
- The critical need for customer acquisition and retention in an era of declining customer loyalty and increasingly sophisticated customers.
- The 1990s trend was for many banks to become full-service firms. Now, however, the trend is toward unbundling, outsourcing and using joint ventures and partnerships to run non-core businesses on a global basis.

To respond effectively to these pervasive pressures, global financial services companies need to develop more comprehensive and encompassing strategies that not only cut costs in the near-term, but also build a more efficient long-term operating model that optimises the value of human capital and reduces operational infrastructure cost.

Fortunately, today's confluence of infrastructure advances and enhanced technological development, growing global pools of talent and continued consolidation of the financial services industry directly

supports two different strategies that, when carried out together, can achieve those goals for both large and mid-sized firms: outsourcing of financial services functions and workplace transformation.

### International outsourcing: A growing trend

The outsourcing of services has grown significantly in the last few years.

The global financial services industry's information technology services outsourcing, for example, is expected to grow from US\$26.6 billion in 2002 to US\$31.3 billion in 2006<sup>1</sup>.

Today, across many industries, one-third of a typical company's budget, including capital expenditure and expenses, now goes to outsourcing<sup>2</sup>. In a recent poll, 50 percent of executives stated that they use outsourcing as a strategic tool, rather than merely a tactical solution. Thus, for global financial services firms, the question is no longer what to outsource, but rather what are the minimum organisational capabilities they need to keep in-house . . . and in their home country.

<sup>1</sup> 'Banking on Outsourcing' by Jeffrey Schwartz, published in VARBUSINESS, 24/2/03.

<sup>2</sup> 'GE Capital International Services', Outsourcing Research Council, PR Newswire, 28/1/03.

## New – and non-traditional – survival strategies for financial services firms *continued...*

Many financial services companies are already outsourcing a wide spectrum of services, processes and back office operations in addition to information technology services such as internet banking, payment processing, customer service, procurement, human resources, regulatory reporting, accounting services, research and call centre operations. International locations of choice include Asia (especially India), Central and Eastern Europe, Australia and the Caribbean. Outsourcing has spread internationally and that trend will continue to grow significantly over the next decade.

For US and UK-based banks, the most desirable locations have an educated but under-employed English-speaking workforce, moderate wages, political stability and an up-to-date technological infrastructure. India is particularly popular with these firms. Citigroup, for example, outsources to 20 different Indian vendors. The Philippines, Malaysia, Morocco and Tunisia are some of the other countries now also actively courting outsourcing business.

America's Citibank and France's BNP Paribas, among others, have partially outsourced their disaster recovery operations to Singapore. French financial institutions are outsourcing to French-speaking African countries and the Caribbean. Some German firms are outsourcing to Central and Eastern

European locations where residents do not necessarily speak German, but do share cultural similarities.

European-based financial firms are also outsourcing internationally to American companies. Deutsche Bank, for example, has outsourced its European financial systems operations to IBM Global Services in a 10 year, US\$2.5 billion agreement, and Paris-based AXA has outsourced its global operations server, mainframe, storage systems and services to IBM with a US\$1 billion on-demand utility services contract. The Canadian Imperial Bank of Commerce has entered into a seven-year, US\$1.5 billion outsourcing agreement with Hewlett-Packard.

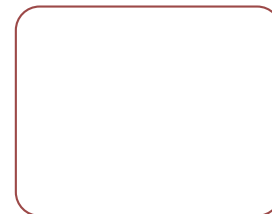
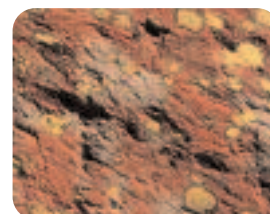
Seemingly unlikely countries can sometimes offer successful outsourcing opportunities. Austria, for example, is generally considered to be a high-cost location. But GE Capital, well known as an international outsourcing pioneer, has built call centres in Burgenland, an economically-disadvantaged region in southern Austria that offers highly educated employees, many of whom speak several different languages, at significantly lower labour costs than elsewhere in Central and Western Europe. Canada's eastern-most maritime provinces like New Brunswick and Nova Scotia, which also suffer from higher-than-average unemployment, have attracted outsource jobs because they offer

a favourable exchange rate to US firms, a highly educated English-speaking work force and government subsidies and other incentives.

Depending on the geographic location, international outsourcing can generate tremendous annual combined labour and real estate cost savings of up to 50 percent. With labour costs comprising 80 percent of a call centre's budget, for example, outsourcing is the strategy of choice.

In addition to cost savings, international outsourcing can often improve a company's quality of service, decrease error rates and improve customer satisfaction because of the high-calibre foreign workers the company can hire and the ability to introduce new working practices/business models. With significantly lower employee wages in outsource countries, companies can afford to hire better-qualified people than they could at home. GE Capital, for example, has hundreds of employees with PhDs on its payroll in India.

Overseas employees who may have been under-employed much of their adult lives are also less likely to leave their new jobs, which minimises turnover, improves customer service and reduces a firm's recruitment training costs. International locations also enable companies to provide 24-hour service on a global basis.



Outsourcing allows financial institutions to differentiate between tactical and strategic processes and functions, freeing them from time and energy spent on the tactical and enabling management and key staff to focus on the core strategic functions such as customer service and innovative, revenue-generating services that set their firms apart in the global marketplace. According to some firms, any function that does not add value to the customer relationship is eligible for outsourcing.

Many countries offer significant incentives (including loans and guarantees) and tax breaks to attract quality employers, particularly where incomes can be earned in hard currencies. These incentives reduce both start-up costs for investment in new facilities and the total cost of service.

Finally, geographical diversification helps a global financial services company get its foot in the door of a region's or nation's budding economy,

which can later support efficient expansion into an emerging marketplace that will then support the capture of new customers.

### International outsourcing strategies

Currently, organisations have adopted three different international outsourcing strategies (see Figure 1).

Figure 1

International Outsourcing Strategy	Description	In Practice
Dedicated Centre	Individual companies set up their own operation centres internationally to serve their customers. They have more control over the operations and hiring - and are able to align the overseas operations more with corporate culture but carry more of the risk.	GE Capital opened call centres in India in the mid-1990s. It improved its business processes and created savings of more than 60%. Between 1997 and 2001, international outsourcing saved the company US\$100 million annually. GE Capital now has call centres in fifteen countries.
Complete Third Party	Companies outsource their customer service operations to third party firms already established in the selected country(ies). Most often these international outsource providers already have a significant presence in the selected country.	Citicorp EFS (Electronic Financial Services) outsourced its call centre operations to mPhasiS, a California-based software company that operates two call centres in India. Third party outsourcing strategy cut Citicorp EFS' labour costs in half and significantly improved the quality of customer service.
Joint Venture	Companies enter a joint venture with another company and/or with a third party outsource provider to service their customers. This strategy splits cost and reduces the risk for individual companies.	London-based Prudential PLC life insurance company entered into a joint venture with India based ICICI OneSource, a diversified financial services group, to establish an outsource call centre in Mumbai, which is expected to save Prudential more than US\$25 million a year.

# New – and non-traditional – survival strategies for financial services firms *continued...*

Whatever strategy a financial services organisation pursues, one key to success is partnership. The outsourcing vendor is a business partner. The outsourcing agreement should be clearly structured on both sides to appropriately integrate day-to-day responsibilities, values, objectives, strategy, management, communication, oversight and service.

Of course, international outsourcing in whatever format a company chooses

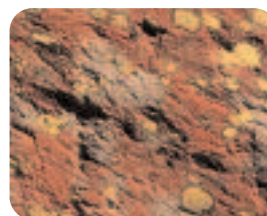
presents challenges and risks, a fact that has led several large US financial institutions, including Bank One, Sun Trust and Washington Mutual, to outsource a few functions within the US, but not abroad, as part of their risk management strategy. Japanese banks, which are just starting to outsource certain functions within Japan, do not outsource to foreign countries because of factors like issues of trust and strict government regulations (see Figure 2).

There was an initial burst of activity in HR outsourcing across Europe two to three years ago though this has since been followed by fewer large contract announcements.

The promise of some of the early high profile contracts ended with critical reviews of their effectiveness – with questions raised about both quality and costs.

**Figure 2: International Outsourcing Challenges and Risks**

Type of Risk	Potential Problem or Concern
Financial	Adverse movements in exchange rates can cause cost uncertainties and, where investments are made, unforeseen financial losses can also be incurred. Additionally, it is more difficult in developing countries to monitor the continuing creditworthiness of an outsourcing provider and manage the related business continuity risks.
Legal and Security	Trust and confidentiality concerns may arise when dealing with third party infrastructure. Intellectual property will be harder to protect. For security reasons, many corporations prefer to keep crucial research and development and the bulk of back office operations close to home.  Outsourcing in emerging countries requires extra attention to local legal and regulatory issues. Investing abroad subjects a business to foreign governmental scrutiny, international trade unions and potential conflicts between the need to maintain confidentiality and the need to transfer technology to lower-wage employees for the good of the global enterprise.
Operational	There are additional risks to consider with vendor selections when outsourcing internationally. Extra due diligence is required to vet potential vendors and to promote contract compliance and quality service thereafter.
Infrastructure	By relocating to emerging countries, there is the potential risk of inadequate or inconsistent telecommunication technology and power supply which can interrupt operations and adversely impact business.
Political	Outsourcing in emerging countries may expose the company and its employees to terrorism and volatile political situations which may adversely impact the operations internationally.
Cultural	Language and cultural barriers may inhibit the provision of quality customer service. International outsourcing places extra pressure on the translation of corporate culture. Certain corporate cultures may not be able to accommodate this form of change.



However, newcomers are now entering the HR outsourcing market in the UK and Europe. In addition, a number are looking to extend their HR outsourcing services into the private sector, to service the middle market from their payroll base, or extend into HR outsourcing from a pensions administration base.

In the US, there is significant growth in the strategic HR outsourcing market evidenced by recent contract announcements, including Exult (Bank of America) and Mellon (Prudential, Amex, BASF, and Lockheed Martin).

Overall, there is a much greater acceptance of HR outsourcing and its benefits, with many companies now regarding this as a real alternative (or supplement) to in-house solutions.

Before embarking on an outsourcing strategy, global financial services companies should determine a strategy for evaluating a range of sourcing options (in-house, JV, outsourcing) for an internal function. This should involve a study of current internal service delivery and capability. Management should consider potential political problems both at home and abroad. A developing country, for example, can suffer from an unstable central government, internal strife, even anti-US and/or anti-UK factions which

can turn an otherwise practical location into a completely impractical one. The Philippines, for example, is a popular choice for outsourced call centres, because its many college-educated workers have strong English language and other skills.

Exim, ECGD and some commercial providers offer political risk coverage that can help mitigate the potential financial effects of such conditions, although these typically do not compensate for the full commercial impact on a firm of the loss of a key commercial centre. Clearly, undertaking a country-by-country risk assessment is a key step when deciding which nations should be short-listed as potential outsource locations.

To ensure adequate performance, moreover, global financial services firms should have mechanisms that allow them to step in, should the outsourcing provider fail to perform adequately or become insolvent. Such mechanisms enable the institution to avoid the negative financial consequences of missed deadlines and damaged client/customer relationships.

Ongoing monitoring of the financial robustness of the provider should be a part of the outsourcing agreement. Financial institutions can specify that

the outsource firm provides statements, audited by firms the institution respects, or employ trusted independent advisors which have an established presence in the country, to regularly monitor their creditworthiness and financial stability.

Infrastructure issues, particularly telecommunications and electrical power failures, impact outsource operations. Thus, service level agreements and the due diligence process should focus on risks to continuity and provide some protection with, for example, a reserve continuity requirement and an investment in a standby power source.

Cultural differences between an organisation's home country and its outsource location may lead to misunderstandings or less-than-ideal service levels. Call centre workers in some nations, for example, have less empathy and patience with customers, which might lose goodwill amongst Americans and Europeans who are used to a high quality of service and a "customer comes first" orientation.

### **Workplace transformation: Improve workforce performance and reduce costs**

Although international outsourcing is expected to grow significantly over the next

# New – and non-traditional – survival strategies for financial services firms *continued...*

**Figure 3: Critical areas of focus for enhancing workplace efficiency**

<b>Drivers of workplace change</b>	<b>Actions for management focus</b>	<b>Benefits</b>
<ul style="list-style-type: none"> <li>Focus on knowledge as the key corporate asset</li> <li>Employee satisfaction &amp; retention</li> <li>Pressure to innovate</li> <li>New alliances &amp; joint ventures</li> <li>Mergers &amp; acquisitions</li> <li>Emerging technologies</li> <li>Over-reliance on virtual communication</li> <li>Changes in real estate portfolio</li> <li>Focus on cost management</li> </ul>	<p><b>Knowledge Workplace</b></p> <ul style="list-style-type: none"> <li>• Perform a gap analysis to develop Knowledge Workplace programmes</li> <li>• Create a cost/benefit analysis balancing individual, business unit and corporate level objectives</li> <li>• Conduct a Knowledge Workplace Assessment, addressing organisational, technological and physical workplace issues</li> </ul> <p><b>Workforce Migration</b></p> <ul style="list-style-type: none"> <li>• Establish management programmes to track, monitor and coordinate the activities, costs and risks associated with the migration</li> <li>• Perform integrated scenario modelling and a comprehensive workforce attrition analysis</li> </ul> <p><b>Occupancy Cost Management</b></p> <ul style="list-style-type: none"> <li>• Assess current occupancy cost structure and compare with industry, peers and best practices</li> <li>• Establish long-term occupancy cost management programmes</li> </ul>	<p><b>Organisational</b></p> <ul style="list-style-type: none"> <li>• Knowledge creation &amp; transfer</li> <li>• Cultural transformation</li> <li>• Increase in employee satisfaction &amp; retention</li> <li>• Learning rate increase</li> </ul> <p><b>Operational</b></p> <ul style="list-style-type: none"> <li>• New product innovation</li> <li>• Quality improvements</li> <li>• Increase in speed-to-market</li> <li>• Efficiency gains</li> </ul> <p><b>Financial</b></p> <ul style="list-style-type: none"> <li>• Enhanced revenue</li> <li>• Cost reduction</li> <li>• Increased returns on investment/equity</li> </ul>

In response to these trends, workplace transformation strategies improve the quality of the work environment, knowledge sharing and worker effectiveness, while often significantly lowering real estate and associated occupancy costs.

By addressing workplace transformation opportunities, financial services organisations can also enhance the performance of their knowledge workers through the development of organisational and physical workplace programmes that foster innovation and knowledge transfer, improve collaboration and ultimately increase financial profitability.

A transformed workplace can also improve morale, which means greater work efficiency, employee retention, productivity and creativity. A comprehensive workplace programme will help successfully transfer the firm’s culture internationally, while also increasing the firm’s sensitivity to and appreciation of the complexity and diversity of working with different cultures globally (see Figure 4).

## Innovative real estate strategies

Right now, it is essential that global financial services companies reassess their real estate strategies. For many

five to ten years, the associated risks can make this strategy problematic for some financial services companies, increasing the pressure on them to find more alternative means of cutting costs. Another vital strategy that seven of the ten largest financial organisations in the world have already begun to implement to gain further cost reductions is workplace transformation.

Future workplace trends require that financial services companies develop speed, agility and innovation. To remain competitive, human capital will be even more critical, but it will need to be managed and developed more effectively in a workplace that improves employee effectiveness.

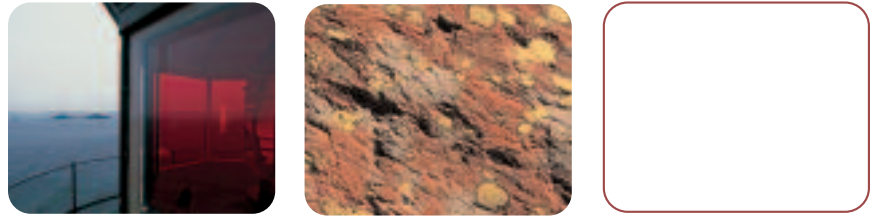


Figure 4: Workplace Transformation Overview



Source: PricewaterhouseCoopers

15 years ago. A key workplace transformation strategy is to perform a comprehensive location and occupancy cost analysis that can help streamline operations and lower occupancy expenses, for example, by as much as 30 percent annually for a major financial institution (see Figures 5-8).

This analysis looks at several occupancy cost factors, including the type of space, the location of company facilities, current space utilisation and workplace standards, the benefits and drawbacks of owning or leasing real estate, current leasing terms, the company's real estate organisation, the firm's planning and decision-making process, facilities management and transfer pricing.

Recently, a global investment bank that was facing increased scrutiny from the

reasons, including outsourcing and changing corporate strategies, financial firms don't necessarily

need the number or size of corporate facilities – let alone the concomitant overhead costs – that they did 10 or

Figure 5: Occupancy Cost Analysis – A recommended methodology

PHASE 1	PHASE 2	PHASE 3
<p><b>Project Planning</b></p> <ul style="list-style-type: none"> <li>Through work sessions and interviews, understand current plans, operations, measurements and relationships of each benchmark peer to assess project objectives</li> <li>Obtain occupancy cost policies, methodologies and available information for each benchmark peer</li> </ul>	<p><b>Data Collection &amp; Modelling</b></p> <ul style="list-style-type: none"> <li>Refine participant questionnaire as a tool to conduct participant interviews and gather related occupancy cost data</li> <li>Adapt data model to import detailed occupancy cost related data</li> <li>Assess model and related assumptions with benchmark peers</li> <li>Complete interviews and data collection</li> </ul>	<p><b>Analysing Data &amp; Summarising Findings</b></p> <ul style="list-style-type: none"> <li>Analyse the qualitative and quantitative information received</li> <li>Normalise and adjust data for special events and location differences for an accurate comparison</li> <li>Synthesise data and benchmark primary and secondary occupancy cost metrics</li> </ul>

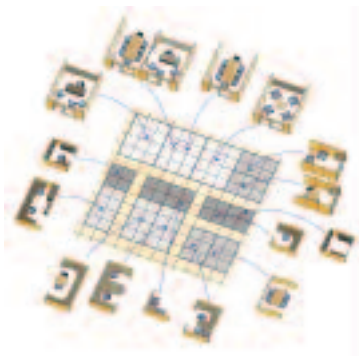
# New – and non-traditional – survival strategies for financial services firms *continued...*

**Figure 6**

**Workplace Best Practices Characteristics**

- Standardised modularity
- Plug-and-play kit or spaces
- Controlled choice options
- Ease of reconfiguration
- Cost-effective change
- Minimal downtime
- Integrated technology
- Universal infrastructure
- Volume purchasing
- eProcurement

**Workplace Flexibility diagram**



financial analyst community wanted to benchmark its occupancy and other costs against its peers with primary business centres in New York, London, Tokyo and Hong Kong. An occupancy cost analysis was performed and created a normalised four-year comparison between its occupancy costs and those of a peer investment banking firm. The global investment bank found that its cost structure was approximately 30 percent higher (and on a much steeper occupancy cost trajectory) than the peer firm, mainly because of its workforce growth and its high cost occupancy standards and policies. With this information, occupancy cost reduction became one of the investment bank’s top priorities – because it wanted to provide “good news” to the analyst community on its ability to reduce cost – and it was able to focus its cost

reduction priorities on specific businesses and geographic locations.

Another important innovative workplace transformation real estate strategy is facility relocation, which can save a global financial services organisation 30 to 50 percent annually in real estate costs, as well as generate significant savings from redeploying jobs to lower wage locations. Facility relocation is often part of a larger international outsourcing strategy and must be properly managed in any significant successful international outsourcing effort.

The relocation process typically begins with a locational analysis that examines one or all of a company’s current and potential facilities from a financial, strategic, operational, transitional, human resource and cultural perspective to determine the various business, cost and risk issues at each

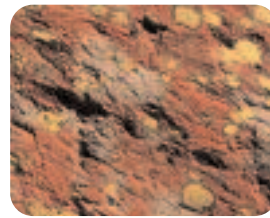
location. For the proposed new geographic locations, the analysis also assesses the local labour markets, transportation and the general business climate. Incentives, for example, often play a major role in the decision to relocate to a particular city, state/province or country.

Creating a comprehensive and well-defined programme management plan and change management plan is essential to ensure a successful transition to the new facilities. Relocation or redeployment also creates an opportunity to implement organisational and technology-based process enhancements within the new facilities.

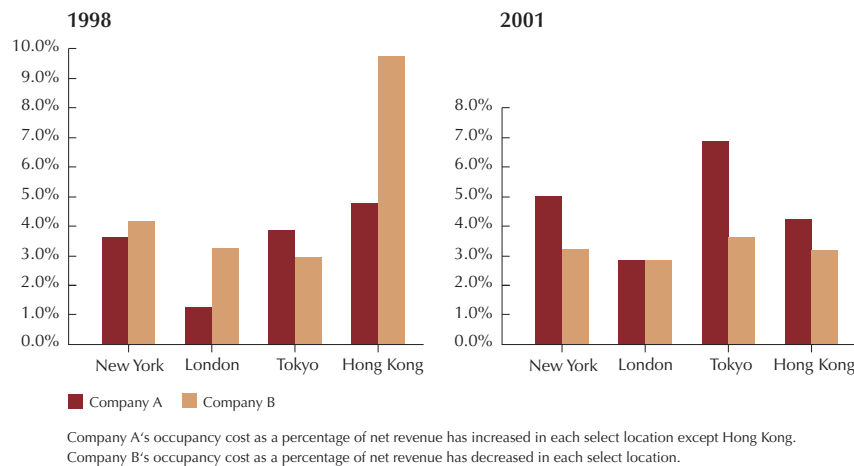
Finally, aligning a facility relocation strategy to the company’s greater organisational objectives and initiatives will create optimal shareholder value through more efficient work processes and systems, thus providing a lower operational cost structure for the long term.

### Acting now: Develop a sense of urgency

Today’s challenges confronting global financial services companies – from greater global competition to increasing government regulations and ongoing socio-political and economic volatility – are not going away any time soon. If anything, they are likely to escalate over the next few years.



**Figure 7: Illustrative Occupancy Cost Evaluation Case Study – Occupancy Cost as a Percentage of Net Revenue by Geography**



and generate impressive cost savings, greater customer service and profitability and improved shareholder value.

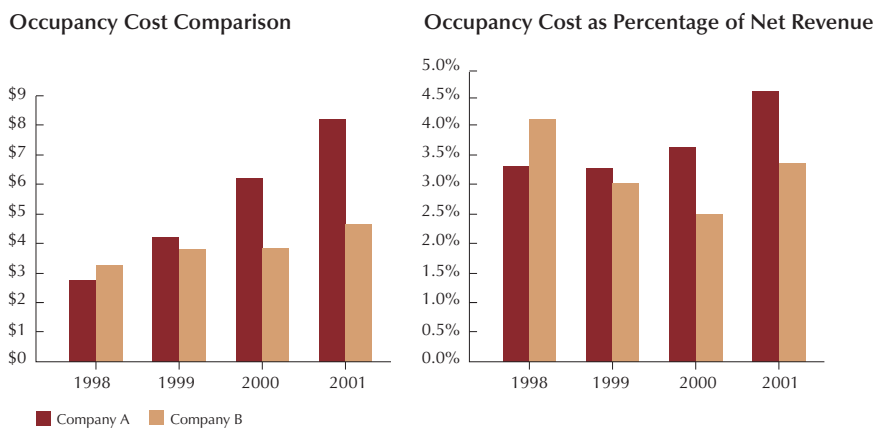
Where should management start? First, conduct a thorough analysis of the company to fully understand its problems, strengths and weaknesses. From that study, develop a strategic plan to eliminate redundancies and standardise the firm's processes, operations, systems, hardware and infrastructure.

Second, identify which parts of your organisation must remain in the home country and which could be provided by a third party, without adversely impacting core values and the value proposition of your company and its responsiveness to market forces. Then, evaluate which of the remaining service functions will most successfully transfer overseas.

Third, identify potential host countries for outsourcing and analyse the country-specific risks and benefits of international outsourcing. This should include determining the terms of a likely deal in each potential country and comparing these arrangements with the costs and benefits of retaining those operations in-house, or outsourcing them internationally.

Fourth, develop the transition analysis and planning required to successfully implement an international outsourcing

**Figure 8: Occupancy Cost Evaluation Case Study – Comparative Analysis Results**



Fortunately, these two strategies of international outsourcing and workplace

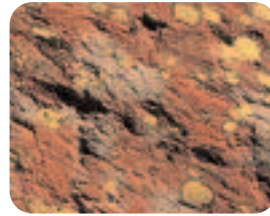
transformation – if implemented properly – can successfully surmount these challenges

## New – and non-traditional – survival strategies for financial services firms *continued...*

programme. Selecting the appropriate partner is a key step in any outsourcing, and it is even more important in international outsourcing. Ensure management's approach to outsourcing is incorporated into the firm's overall strategic plan.

Finally, consider whether there are cost and other benefits that may be generated from adopting workplace transformation best practices. Consider developing organisational and physical workplace programmes, conducting a comprehensive occupancy cost analysis and exploring the risks and benefits of facility relocation.

Those organisations that incorporate these strategies into their overall business plans are more likely to succeed in the coming years, while those who fail to take advantage of these opportunities now may be left behind in the competitive global economy.



# Central and Eastern European banking: European Union accession and other issues

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by Jim Kernan, Alper Onder and Tam Basunia



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Banking in Central and Eastern Europe (CEE) is at a turning point. Previously understood as the former communist states, plus Turkey, the region is splitting into distinctive parts. This split is primarily driven by the fact that some countries will join the European Union (EU) in a little under a year, others 3 to 5 years later, in a generation, or perhaps not at all.

The current economic downturn in the region is affecting bank performance, and with the large number of privatised banks on the market, consolidation seems unavoidable. Recent surveys and other data indicate that there is also much EU entry related work to be done.

### Emerging from a Failed Experiment

After the fall of communist regimes in 1989 and the early 1990s, much of the banking sector in Central and Eastern Europe was little more than an administrative cash management arm of the state. Most of the population in these countries had little need for a bank account or any other bank products – if, indeed, there were any. In Poland, for example, citizens with bank accounts were usually limited to those who were in the long-term automobile or apartment

savings programmes, meaning that they put money in a special bank account in the hope of obtaining one or the other at some undefined time in the future.

Under the previous regimes, a shortage of cash was less of an issue. People did not really have much on which to spend their money, beyond basic consumer goods and in many cases even these basic consumer goods were lacking.

With a population of 410 million, CEE itself is just larger than the current European Union member states, at 378 million, with a geographical size over six times larger than the current EU (see Figure 1). However, these population and land mass numbers do not translate in an intuitive manner into an equivalent level of economic or banking strength:

for example, Russia, with a population of 145 million, has a GDP equal to that of Holland with a population of 12 million, whilst Poland has a population of 38 million and a GDP which is half of Holland's. Even though banks are the major source of capital in the region, there is little doubt that CEE will need both foreign direct investment and European Union funding to help close this gap.

These raw figures reveal little about the sophistication of the markets themselves. Russia's economy is highly dependent on natural resource exports, and Poland resembles many European economies from the 1970s and 1980s. Like those economies, it is having difficulty weaning itself from unprofitable over-investment in heavy industry, such as mining and steel production.

Figure 1: CEE Region – geography

	CEE	EU	USA	EU Aspirants
Population (m)	410	378	278	172
GDP (\$Bn)	2,823	8,472	9,963	1,350
Average GDP per Capita (\$000)	7	22	36	8
Area (km <sup>2</sup> 000)	22,558	3,238	9,629	1,864

# Central and Eastern European banking: European Union accession and other issues *continued...*

**Figure 2: Sector profile**

	Russia	Poland	Hungary	Czech Republic	Turkey	Germany	United Kingdom	Other	Total
<b>Number of Banks</b>	1,930	71	33	38	79	859	398	568	2,719
<b>Total Assets (\$Bn)</b>	106	114	40	86	106	4,901	5,140	103	555

**Figure 3: Ownership profile**

	Russia	Poland	Hungary	Czech Republic	Turkey	Germany	United Kingdom
<b>% of total assets privately owned</b>	25	77	95	100	73	75	100
<b>% of total assets foreign owned</b>	1	70	70	94	6	6	53

**Figure 4: Top 20 banks – country analysis**

Slovenia	Poland	Hungary	Czech Republic	Turkey	Russia
3%	40%	4%	23%	19%	11%

In terms of bank assets, Poland, Russia and Turkey have \$114 billion, \$106 billion and \$106 billion respectively, each a fraction of the assets banks in the United Kingdom and Germany hold, which are around \$5,140 billion and \$4,901 billion respectively (see Figure 2).

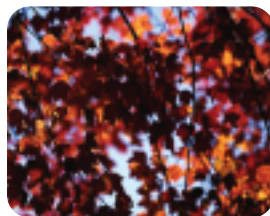
Yet many of the CEE countries have a higher percentage of their banking sector assets in private hands than Germany (see Figure 3). Unsurprisingly, the largest 20 banks are concentrated in the largest economies in the region (see Figure 4).

## The Orbital Pull of the European Union

Most of the countries in the region aspire to join the European Union; eight of them are set to join in May 2004 – and this has far reaching repercussions for the banking market. Banks in countries closer to EU membership will feel changes the soonest, as they have to adopt a wide range of legal and regulatory standards of European Union law in the *acquis communautaire*<sup>1</sup>.

From a market practice point of view, banks in countries close to membership need to act as if they were already in the EU. In this regard, they need to have implementation programmes for issues beyond the current *acquis communautaire* to look at those regulatory changes that will take place in the EU just after they join. However, as we will see later, it is not clear that CEE banks are doing so.

<sup>1</sup> The *acquis communautaire* is the entire body of legislation of the European Communities and European Union. It includes the primary legislation (i.e. the treaties), the secondary legislation (i.e. legislation derived from treaties: regulations, directives, decisions, recommendations and opinions) as well as judgements laid down by the Court of Justice. The *acquis communautaire* constitutes a large volume of text - over 80,000 pages. Applicant countries must adopt, implement and enforce the *acquis communautaire* before they can join the EU.



Countries with aspirations to join the EU can be divided into four categories. These include:

- Wave 1 Accession that will join the EU in 2004: This well-defined group includes the Czech Republic, Estonia, Hungary, Latvia, Lithuania, Poland, Slovakia and Slovenia.
- Wave 2 Accession that seeks to join the EU in 2007: Bulgaria and Romania – and Croatia has recently stated it wants to join this group.
- Aspirants to join the EU in the longer term include Bosnia & Herzegovina, Macedonia, Moldova, Montenegro, Serbia, Turkey and Ukraine.
- Several countries for whom the aspiration to join the EU appears to be lacking or is unclear. Such aspiration can be unclear, as the EU has not definitively specified how far east “Europe” extends. Some would suggest that even Turkey could find itself in this category. The general expectation is that there will be more countries that will seek to join the economic security of the EU than the EU may want to accept.

The region is diverse. Some countries such as Poland, have sophisticated banking and capital markets and will be looking to export capital in the near future. Other countries still face issues of establishing the core basics of a market economy. Where economic reform is slow,

### CEE Banking Vignette: Poland

- As of June 2002, there were approximately 75 commercial and 660 cooperative banks operating in the Polish market.
- Foreign-owned banks dominate the market, with a 70% share of total assets, 81% share of equity and about 67% of deposits. Cooperative banks, although large in number, have only marginal importance (4% of total assets and 5% of deposits). The five largest banks control more than 50% of assets, hold 57% of deposits and granted 47% of loans.
- There are only three banks still controlled by the State Treasury (BGK, BGZ, PKO BP). Plans for privatisation of PKO BP have been under discussion for seven years, and the tender for a privatisation advisor is now underway.
- Consolidation was a major trend in the Polish banking sector until two years ago. However, indications are that this activity will pick up in the near future. There are a number of international players on the market with a relatively small market share (approx. 2%) that would otherwise not be acceptable to their management. As such, one could expect that the likes of Citibank, HSBC and AIB will push hard to get into a top three position, requiring a marketshare of over 10%. Domestic champions, such as Millennium Bank, are also moving aggressively. Obviously, more banks want to be on top of the market than there is space. This is likely to lead to consolidation and others exiting the market.

such as in Ukraine or the Central Asian Republics, or new, such as in Serbia, banks face significant challenges and the constraints of a morbid economy.

### The Private Sector Takes the Lead

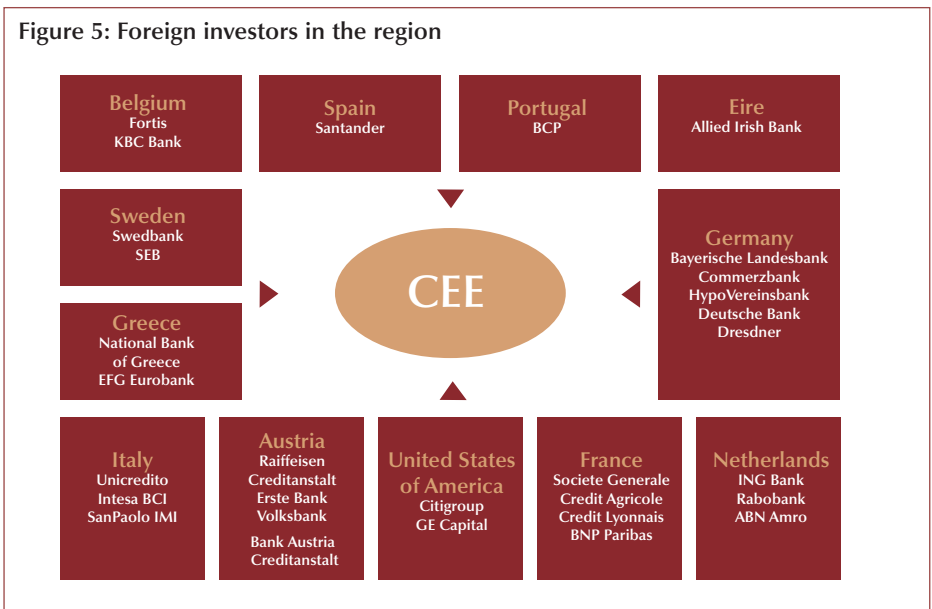
Privatisation has taken hold firmly within large economies of the Wave 1 and Wave 2 EU Accession states, as well as in Turkey.

In a positive aspect for the region's development, much of this privatisation is linked with foreign inward investment, so that many banks can make up for lost time with access to best international banking practices.

As we can see, the Czech Republic, Hungary and Poland all have a higher percentage of their banking sector in private hands than Germany. This trend

# Central and Eastern European banking: European Union accession and other issues *continued...*

Figure 5: Foreign investors in the region



in privatisation should continue. In Poland, three of the largest banks are still state owned; however successive governments and various political opinions have agreed that there is a need to privatise at least a part of each of these banks, noting the need for private capital and expertise to ensure growth. It is unclear, however, whether the private investor will be given enough ownership for it to be meaningful.

Interest in the region is diverse, with banks in over twelve other countries already having sizable holdings, although there remains a lack of significant investment from UK banks (see Figure 5).

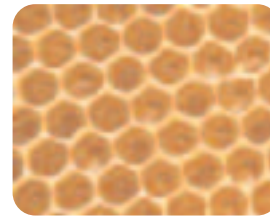
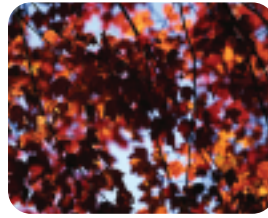
Nevertheless, this diverse interest will intensify competition and allow the region, in a short period of time, to close the technology and services gap. Policy makers, in the Accession countries in particular, have sought to ensure that there is a balance of international stakeholders, such that banks and capital from one country do not come to dominate in their markets. However, whether stakeholders are paying enough attention to their interests in the region is unclear, as we discuss shortly in regards to Basel II.

A clear discrepancy exists between the number of bank assets and the number of banks operating in the region in

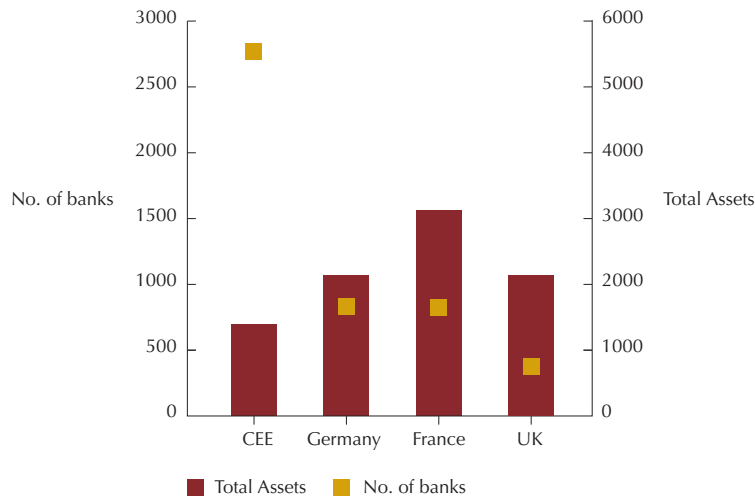
## CEE Banking Vignette: Hungary

- There are 27 commercial banks, 13 specialised financial institutions (including three mortgage banks), 183 savings cooperatives and 7 loan cooperatives operating in the Hungarian market.
- Compared with Western European countries, banking penetration is still relatively low as total banking assets accounted for 61.6% of GDP at the end of 1H 2002.
- Concentration is relatively high, with the five largest banks controlling 58% of the sector.
- The Hungarian banking sector is dominated by foreign capital, with non-residents owning about 70% of banking assets as at 1H 2002.
- Retail banking is growing, with an increase of more than 150% in loans to households during the first half of 2002. OTP, the largest local bank, still keeps a dominant position with 44% of all household deposits and 38% of household loans.

comparison to the major economies in the EU (see Figure 6). While the former can be expected to grow slowly to converge with the European average over a generation or



**Figure 6: Banking institutions and total assets**



two, the latter is likely to decrease swiftly due to competition. This will impact the large number of small banks in CEE, many of which are captive to a specific industry or even to one client. This can be the case especially in Russia, where the huge industrial conglomerates can make or break a bank.

## A Revolution in Retail

A recent PricewaterhouseCoopers survey of retail banking and consumer finance in the region, entitled *Retail Banking and Consumer Finance in Central and Eastern Europe*<sup>2</sup>, shows how the retail banking sector in CEE has grown rapidly.

The advanced state of privatisation and high levels of participation of foreign investors have brought in new technologies, new products and various efficiency measures. Tough competition in the corporate banking segment has encouraged banks to focus more on non-interest income business and retail clientele specifically.

Implementing more advanced technologies has made the offering of retail banking services much broader and more accessible to individuals. Direct banking, currently developing rapidly across the region, is an example

of how new technology is altering the landscape of banking services.

Despite substantial differences among the individual countries, the retail sector in the CEE region shows some common characteristics:

- Consumer finance has been developing rapidly as clients lose their fear of being indebted and have gained more confidence in their ability to repay outstanding loans. These services have to date been provided primarily by non-banking financial institutions, but banks have recently discovered the potential of the segment and are becoming significant players.
- Housing finance has developed in some form in virtually all of the CEE economies. Historically, building societies, usually formed by foreign institutions in cooperation with a local bank, were leading providers of housing finance due to direct and indirect support of governments. However, mortgage banks have recently taken the lead as a result of favourable interest rate developments and their alternate offering.
- Payment (debit) cards have become increasingly popular, growing in number annually by 50% in some countries and over 100% in others. Although debit cards have gradually become commonplace, credit card penetration remains low.

<sup>2</sup> visit [www.pwc.com/cz](http://www.pwc.com/cz)

# Central and Eastern European banking: European Union accession and other issues *continued...*

## CEE Banking Vignette: Czech Republic

- As of December 2001, there were 38 commercial banks operating in the Czech market, of which 17 were foreign-owned entities and 9 were branches of foreign banks.
- The sector is concentrated with three large banks (Komerční Banka, Česká Spřítelna, ČSOB) accounting for 77% of total banking assets and 83% of deposits.
- In the summer of 2001, the privatisation of the Czech banking sector was completed by the sale of Komerční Banka to Société Générale. In 2002, Unicredito Italiano bought an 85% equity stake in Živnostenská banka from Bankgesellschaft Berlin, and in 2003 Union Banka, a smaller bank which is privately owned but not part of a major international banking group, has fallen into financial difficulty and its future is uncertain.
- The “Big Three” are followed by HVB (created by the merger of Hypovereinsbank CZ and Bank Austria Creditanstalt in the summer of 2001), GE Capital Bank (originally Agrobanka), currently strongly developing direct banking, Živnostenská banka, concentrated mainly on SMEs and high net worth individuals and Citibank who have aggressively marketed loans for private entrepreneurs and SMEs and have strongly developed private banking. In terms of client numbers and volumes of total assets, the fastest growing bank is eBanka (owned by Česká pojišťovna, the leading Czech composite insurer) which is focused primarily on Internet banking.
- Retail banking was under-developed throughout the 1990s, but it has recently become the fastest-growing segment.

Basel II will be implemented in the European Union via a Directive known as Capital Adequacy Directive 3 (CAD3). The Basel Committee published its third consultative paper (CP3) and its third quantitative impact study (QIS3) in the second quarter of 2003, essentially finalising its work. As such, the full political weight of the reform will fall on EU authorities. The plan is to finalise the Directive in 2004 and have it come into force in 2006/2007 through national adoption arrangements. Banks in the first and second wave of the accession will need to comply with the new rules in the same way and timeframe as those banks already in the EU.

CAD3 has major implications for CEE banks, not the least of which are timing and reputation. Timing is critical, as at their core Basel II and CAD3 require banks to gather a greater amount of information about their businesses than ever before. However, the requirements also say that banks need to base their analysis in part on information going back several years. With an expected start date of 2006, member states and accession state banks need to have their credit risk models approved and begin to populate them.

A recent PricewaterhouseCoopers survey<sup>3</sup> indicates, however, that banks have much to do to prepare for Basel II. The survey

## Basel and Beyond

Basel II is the largest challenge that CEE banks seeking or considering EU accession will face in terms of changing the way they do business and manage risk, particularly as the European Commission has indicated that these new requirements will apply to all banks in the region.

- Direct banking (mainly internet and telephone banking) has been growing as Central and Eastern Europeans are avid users of new technologies. The current low penetration of PCs and internet, together with security concerns, prevent faster development in this area.

<sup>3</sup> For the results of the ‘CEE Basel II Bank Preparedness Survey’ please visit the PricewaterhouseCoopers Poland website: [www.pwc.com/pl/eng/about/svcs/abas/ue/iss8basel.html](http://www.pwc.com/pl/eng/about/svcs/abas/ue/iss8basel.html)



clearly reveals that there are a number of similar issues facing banks across CEE. Banks across the region have a good level of awareness of Basel II including its implementation schedule (see Figure 7).

However, there appears to be a lack of attention to actual implementation. The survey, finished in late 2002, found that more than 40% of the banks surveyed have not taken any action whatsoever to comply with Basel II and few banks had budgets or people designated to manage the issue (see Figure 8). Continued complacency will lead to significant compliance issues in the future. With the high degree of foreign participation in the region's banking sector, banks indicate that they have received little in terms of guidance from the head office.

Competitive disadvantages, particularly in light of EU accession, could emerge if some of the region's leading banks fail to qualify for more sophisticated approaches to credit/operational risk in Basel II and have to meet the full capital adequacy requirements. They will be competing directly with banks in more developed economies that have already been working on the issue for some time.

Many banks in the region report that they are using or are preparing to use IFRS. More than 75% of responding

**Figure 7: Awareness of proposed content and time schedule of Basel II**

None	Partial	General	Substantial	Full
5%	15%	34%	20%	26%

*Source: PricewaterhouseCoopers CEE Basel II Bank Preparedness Survey 2002*

**Figure 8: Dedicated resources appointed to deal with Basel II**

Part time specialist	Part time team & Full time specialist	None	Part time team & Part time specialist	Full time team	Part time team	Full time specialist
25%	2%	32%	2%	14%	23%	2%

*Source: PricewaterhouseCoopers CEE Basel II Bank Preparedness Survey 2002*

banks are already using IFRS as the primary or secondary reporting framework. This frequency is higher than in the EU member states, as CEE began looking at IFRS earlier when it started building free market accounting standards after 1989.

The accession state banks face so many near-term issues that they are unlikely to move on Basel II unless their regulator, the competition or their foreign shareholders, if they have any, begin to demand action.

Another issue is that the accession country banks, in particular, are going through a phase of retoolings and high turnover. The staff profile many inherited was not necessarily one that a modern bank requires. There have been many examples of redundancies followed by banks hiring highly qualified people as well as those

who will work their expanding retail networks. Many branches have high overhead costs in huge old brick and mortar locations, are over staffed and not located where the clients are. Banks are rather more interested in expanding into the new shopping malls with plasterboard and glue.

### Russia – A direction of its own

The Russian Federation is taking a direction of its own and may not even be interested in alignment with the EU. Russia is expected to set different regulatory standards and seek economic advantage through the structuring of its financial sector aligned to only the basic global regulatory practices, such as those required by FATF. Whilst there have been improvements in recent years in the economic situation in the Russian Federation, the economy continues to

# Central and Eastern European banking: European Union accession and other issues *continued...*

## CEE Banking Vignette: Slovakia

- There are currently 21 commercial banks operating in Slovakia.
- Slovenská Sporiteľna is by far the largest bank traditionally involved in the retail sector. The bank was privatised in 2000 to Erste Bank of Austria and with more than 2.2 million clients and 440 branches it is the clear market leader in retail banking.
- Všeobecná úverová banka (VUB) is the second largest bank in Slovakia, focused mainly on corporate banking but with a growing retail presence through 230 branches. The bank was sold to IntesaBci SpA as part of the banking sector privatisation in June 2001.
- Other banks with significant exposure to retail banking include Tatrabanka, majority owned by Raiffeisen Zentralbank Austria; Poštová banka, which is majority state-owned (the government has been in the process of looking for a strategic investor – ING, Česká pojišťovna and Tatrabanka are claimed to be interested parties); and Polnobanka, which was acquired by UniCredito Italiano in 2000. Istrobanka, formerly owned by Slovenská poisťovňa (the dominant composite insurer), was sold to Austrian Bawag in December 2001; and Investičná a Rozvojová banka (IRB) was taken over by OTP of Hungary in August 2002.
- A significant position in the retail sector is held by specialised housing finance institutions, such as construction savings banks (“building societies”) or mortgage banks which are typically run as arms of larger banking institutions.
- At the end of 2002, the National Property Fund approved the sale of a 60.07 % stake in the smallest Slovak bank to the Austrian Meinh Bank for SKK 360 million (USD 7 million) and thus Poštová banka remains the only Slovak bank owned by the State.

## CEE Basel Basics

- Less than a third of the banks surveyed had resources budgeted for Basel compliance or were able to provide any indication of the anticipated cost of Basel. Where indications of expected expenditure were provided, they varied enormously – from €300, 000 to €57 million.
- Pillar 1 – Credit and operational risk approaches: Nearly two thirds of our respondents indicated that they expected to adopt an internal ratings-based approach and nearly

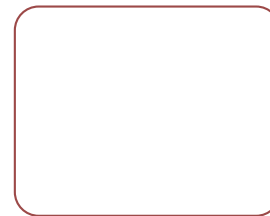
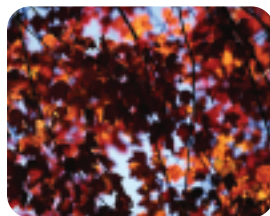
one third of the respondents said that they planned to adopt an internal measurement-based approach to operational risk. Taking into account the complexities of Basel II, both for credit and operational risk, this may not be a totally realistic goal in the region given the amount of work devoted to the issue to date. Historic data is lacking for both credit and operational risk purposes.

- Pillar 2 – Communication with the regulator: Less than 25% of the respondents indicated that they were

involved in any significant direct dialogue with their regulators. Over a third did not have any communication with the regulator at all either directly or through an industry association.

- Pillar 3 – Disclosure: International Accounting Standards (IAS/IFRS) are widely used and 75% of participating banks use IAS (IFRS) as their primary or secondary reporting framework. These provide a consistent, robust and harmonised foundation for reliable and relevant disclosures across the region.

Source: PricewaterhouseCoopers CEE Basel II Bank Preparedness Survey 2002



display many characteristics of an emerging market. These characteristics include, but are not limited to, the existence of a currency that is not freely convertible in most countries outside the Russian Federation, a low level of liquidity in the public and private debt and equity markets, and double-digit inflation.

The banking sector in the Russian Federation is particularly sensitive to adverse currency fluctuations and economic conditions. Moreover, the need for further development in the bankruptcy laws, the absence of formalised procedures for the registration and enforcement of collateral, and other legal and fiscal impediments contribute to the difficulties experienced by banks currently operating in the Russian Federation.

In Russia, the banking sector was one of the first sectors to be demonopolised. This began at the start of market reforms in the early 1990s. By the end of 2002, commercial banks numbered just under 1,300 which represented a reduction from the pre-global financial crisis in 2001. However, the banking industry still remains heavily undercapitalised. The vast majority of Russian banks are small, undercapitalised and limited in the range of services they provide. Only in 2002 did the market first begin to

### CEE Banking Vignette: Romania

- The total assets of the consolidated banking sector in Romania amounted to €13.1, billion, representing more than 30% of the country's GDP.
- The banking sector was consolidated in 2002, after the profound restructuring that took place between 1999 and 2001.
- At the end of September 2002 there were 42 banks in total operating in Romania. The Romanian banking market is fairly concentrated. The top three banks by banking assets, Banca Comerciala Romana (BCR), Banca Romana Pentru Dezvoltare – GSG and Casa De Economii Si Consemnatiuni (CEC), account for some 54% of the market.
- Two foreign banks entered the market in 2002: Micro Bank (EBRD, IFC and Commerzbank) and Nova Bank (Russian and Swiss Investors).
- The second attempt to privatise BCR (the largest bank in the country) failed. The lack of investors was attributed to the poor international environment in the banking sector. The Government is currently preparing a new sale strategy for BCR.
- 2002 saw a large expansion of retail banking business and a substantial decline in interest rates denominated both in Romanian Lei and global currencies.

see any significant expansion in consumer credit, whereas banks had previously focused almost exclusively either on the financial markets or extending loans to affiliated companies.

State-owned Sberbank, which reported assets of some \$30 billion in 2002, has a significant competitive advantage over other banks due to its size and extensive branch network, to say nothing of its state-backed deposit guarantee. As a result, it dominates the market.

A number of more entrepreneurial banks have developed into holding companies for financial or commercial conglomerates, which control significant holdings in financial institutions and industrial enterprises. These banks have been increasingly active in acquiring industrial enterprises.

Statutory financial reporting and accounting are performed in accordance with Central Bank regulations. The most significant differences to international practice are in the areas of loan

# Central and Eastern European banking: European Union accession and other issues *continued...*

## CEE Banking Vignette: Bulgaria

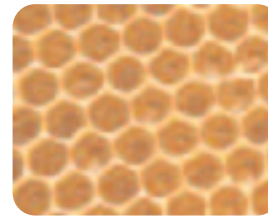
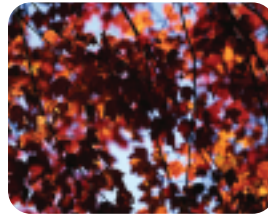
- 2002 was one of the most dynamic years for the banking sector in Bulgaria.
- In September 2002, there were 35 commercial banks operating in Bulgaria (including seven branches of foreign banks). Total assets of the consolidated banking sector represented 46% of the country's GDP.
- The number of former state-owned banks, purchased by foreign investors, increased by one in 2002. In October, HVB paid €82.5 million for 99.59% of Biochim Commercial Bank.
- The following banks, originally state-owned, have been acquired by foreign investors: United Bulgarian Bank (UBB), Bulgarian Post Bank, SG Expressbank, Hebrosbank, Bulbank and Biochim.
- With the completion of the privatisation of DSK Bank, due to be sold in the first half of 2003, the bank privatisation process in Bulgaria will be completed.
- The banking sector in Bulgaria is relatively concentrated with the top three banks (Bulbank, UBB and DSK Bank) accounting for approximately 54% of the total banking assets.
- Bulbank (formerly the state foreign trade bank) is the largest Bulgarian bank with a 24% market share. The bank was acquired by a consortium of UniCredito and Allianz in 2000 and reported a pre-tax profit of circa €50 million for the first nine months of 2002 – 72% of the consolidated pre-tax profit reported by Bulgarian banks for the same period.
- The ownership of the other significant players is also foreign: UBB (National Bank of Greece), Bulgarian Post Bank (consortium between EFG Eurobank Ergasias and AIG), Hebrosbank (Regent Pacific) and Biochim (HVB).

provisioning and valuation of securities and investments. The Central Bank is working towards the introduction of IFRS within the banking sector, provisionally planned for 2004.

Mortgage lending is underdeveloped for one reason: the housing component of the social system inherited from the USSR makes it nearly impossible to free an apartment from a person registered

as residing there, whatever his property rights, without providing him with substitute housing. Until this issue is tackled, mortgage companies will be forced to offer equally tortuous lending terms, which only those with uncommon resolve will be able to meet. At the moment, only a select few banks have been intrepid enough to launch mortgage lending programmes.

Consumer credit is a new, but rapidly growing, segment of the Russian banking industry that has gained popularity since 2000. So far, only a few banks have risked venturing into the great unknown of consumer lending, even with the lack of any reliable credit rating system for assessing the creditworthiness of individual consumers. Despite interest rates that can be some 1.5 times higher than the rates for usual lending, consumer credit programmes, which boast rapid loan decisions and require minimal paperwork, have proved to be a success with customers. Banks involved in consumer lending have reported repayment rates as high as 98% (as compared with the 90% forecast in typical business plans), while retailers have noted 75% growth in sales due to consumers' increased ability to choose better and higher-priced goods. Overall, the Ministry of Economic Development and Trade estimates that consumer lending grew by 40% in the first nine months of 2002. However, the market is still in its infancy.



After a forced four-year absence from international financial markets, Russian borrowers returned with a vengeance in 2002. As growth in developed markets slowed in the wake of the collapsing hi-tech bubble, the ever-growing Russian economy and high oil prices have prompted a review of the Russian risk, which has once again been deemed bearable. In turn, this has encouraged a slew of Eurobond issues and syndicated loans at premium rates, at least from the local perspective, of around 10%, including a jumbo \$1.75 billion bond issue by Gazprom in early 2003, which was the largest by a publicly traded emerging market company. In 2002, Russian companies placed \$3.7 billion worth of Eurobonds, or three times the amount of such debt floated in 2001.

### Issues Still to Address

Foreign banks that wish to enter the CEE market have a number of considerations to address.

**Growing economic strength:** Average incomes are low and will take generations to reach levels found in Western Europe. Average incomes in Wave 1 and Wave 2 EU Accession states are below 45% of the current EU average. As such, all parts of these countries will qualify for significant EU development aid via the Structural Funds and other programmes. This will provide a recession-proof base cash flow

### CEE Banking Vignette: Ukraine

- As of October 2002, there were 152 commercial banks operating in Ukraine, including 11 foreign-owned entities. The market remains relatively small in size with total banking assets of €119 billion as at October 2002.
- The sector is dominated by 12 banks, which in all account for over 59% of total banking assets. Four of these banks – Prominvest, Ukrsots, Ukrexim and Oscchady (Savings bank) – are former Soviet banks. Seven banks were established in the 1990s, including Aval, the largest in terms of assets.
- The share of non-performing loans in the credit portfolio of Ukrainian banks decreased from 20% in 2000 to less than 7% in 2001.
- The payment system is considered to be reliable – all domestic payments are carried out electronically through a clearing centre and 42 branches of the National Bank of Ukraine (NBU).
- According to the NBU, in the first nine months of 2002, the entire banking sector made an aggregate profit of approximately €84 million compared with a profit of €109 million in the fiscal year of 2001.
- Credit Lyonnais was the first foreign bank to register in Ukraine in 1993. At present, Raiffeisen is the largest foreign bank in the country, despite its relatively late entry. In 2001, Société Générale and Rabobank closed their operations in the Ukraine while other foreign institutions raised concerns about the state of the Ukrainian banking sector.

into the region and also allow banks to earn on short-term 'bridge' financing, being the time between when the investment actually begins to the time when the Commission or national government reimburses the beneficiary.

**Restructuring bank debt:** More needs to be done to allow for restructuring of non-performing loans in CEE, rather than

just writing them off or letting them drift unresolved.

**Enhancing conduct of business:** Conduct of business practices are evolving and the region is coming to grips with the need to deal in a stronger manner with fraud and money laundering. EU membership brings credibility, but reputations are much more easily damaged or destroyed if the new

# Central and Eastern European banking: European Union accession and other issues *continued...*

## Turkey – Reforms after the crisis

Recent reforms in the banking sector in Turkey have been driven by the establishment of the Banking Regulation and Supervision Agency (BRSA) in August 2000 and by the financial crisis the country faced in February 2001. Following the exposure of weaknesses in the banking sector in the financial crisis, BRSA was in a position to act.

One of the major changes made was to require triple audits of each private deposit taking bank to, in part, determine capital adequacy and capital shortages under Bank Capital Strengthening Programme. Further, starting from July 2002, all the banks began to use inflation accounting. Overall the accounting standards for banks have been moved to a model that is very similar to IFRS. The new disclosure requirements, again very similar to IFRS, are mandatory as of 31 December 2002, and the most recent financial statement will now be prepared according to these standards.

Finally, all banks now have quarterly limited reviews to accompany the full audit at year end. While 73% of Turkey’s banking sector is in private hands, if these reforms continue in a positive direction then there is every reason to believe that foreign participation into the Turkish banking sector will increase above its current 6%.

Based on a recent PricewaterhouseCoopers survey in Europe, *Regulatory Compliance: Adding Value<sup>4</sup>*, banks in both Western and Eastern Europe will all need to make changes. Whereas in continental Europe the internal audit department in banks has historically undertaken the compliance function, with the new ISD this will change. Compliance in general is expected to develop as a profession and an ex-ante operational control within banks.

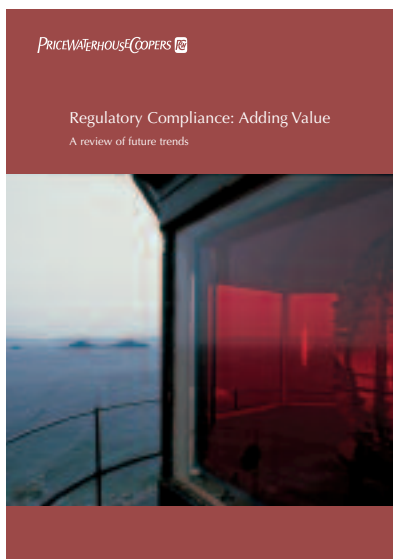
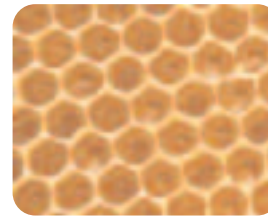
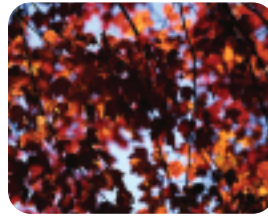
**Strengthening the rule of law:** In preparing for and joining the EU, the importance of a well functioning society and economy based on the rule of law becomes increasingly important. An efficient and knowledgeable court system and swift punishment of financial crimes, frauds and money laundering are increasingly necessary. While the *acquis communautaire* will have been adopted in each accession country parliament, implementation has lagged, and it may remain a fiction for some time. It is not at all clear if the courts are prepared to enforce these legal changes. Rapid legal change is common in CEE, and experience in CEE courts to date is not encouraging. It may be several years after accession before the court system digests the new regime and it is applied consistently across the new member states and the region.

regulatory regimes are not adhered to or if business practice does not stamp out fraud, money laundering and disrespect for minority shareholders.

**Building a better compliance function:** Another regulatory issue banks in the region will need to face is in the area of the compliance function. The Committee for European Securities Regulators (CESR) functions at the behest

of the European Commission to develop recommendations for enhancing the common market in the area of asset management. The new Investment Services Directive (ISD) will implement some of CESR’s recent recommendations regarding the need for asset management firms, including banks, to create a separate compliance function.

<sup>4</sup> See in full at [www.pwc.com/pl/compliance](http://www.pwc.com/pl/compliance)



In many of the accession states the courts are overloaded and cases can take years. Courts still lack a cadre of judges and prosecutors comfortable with financial and accounting issues. There are a growing number of cases at the European Court of Human Rights (ECHR) from CEE countries against their own court systems or their decisions. For instance, of the 13,858 cases filed in 2001 at ECHR, over 12% (1,763) came from Poland. In this environment, the European Court of Justice can probably expect a significant increase in cases following the accession of the Wave 1 countries, and banks and clients may only find their answers there.

The relative weakness of legal rights around property title and collateral has restrained much growth in traditional retail banking sectors and requires higher returns commensurate with this risk – a contrast to the situation within the EU.

Most of the countries in the region are no longer on the money laundering and fraud list of the OECD’s Financial Action Task Force (FATF). At this time, only Ukraine faces significant issues to resolve, as FATF has removed Russia and Hungary from its list in the last 18 months. However, while local law may be in line with FATF requirements, it is not at all clear that individual banks are acting. Our own interviews indicate that banks know they are or may be used for money laundering, but see a solution as beyond their current resources.

**Entering the Euro Zone:** The question on adopting the euro is only “when”, and not “if”, for the accession states. Unlike the United Kingdom and Denmark, the new accession countries resigned from any opt out clause in their negotiations as to adopting the euro. It is clear, however, that their weaker economies will only benefit from eliminating currency risk with their largest trading partners and will remove much of the monetary decisions from caprices of national politics.

## Conclusion

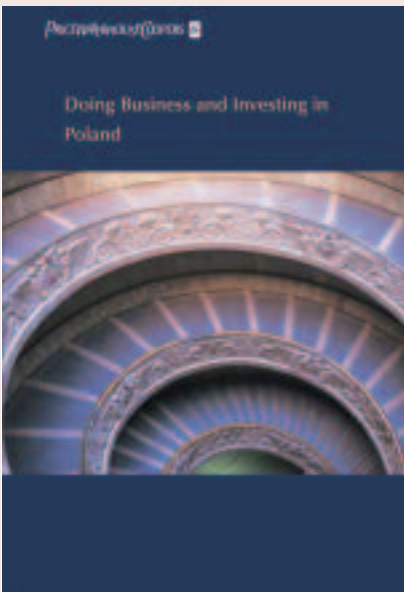
The banking sector in Central and Eastern Europe has developed significantly in the past 15 years. Most of the EU accession countries seem to have come to the conclusion sooner or later that the only way to obtain a world class banking system – something these countries missed out on building over the last 50 years – was to privatise all or a large portion of the sector. Foreign investment and technology transfer have brought radical change, innovation and real competition to the sector. The EU accession countries are now, or will shortly be, in compliance with the *acquis communautaire*, so that at a regulatory level they should differ little from the current member states.

The banking market in CEE still faces many challenges. Certainly there will be set backs, but these will largely provide international banks an opportunity to enter the market if they have not done so already. For banks operating in stagnant, mature markets, CEE presents a lower risk option to access new markets. The potential growth in the region means that some of the banks in smaller western European countries that have already invested in the region are likely to see CEE returns outgrow their domestic

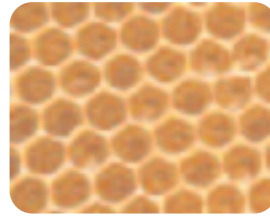
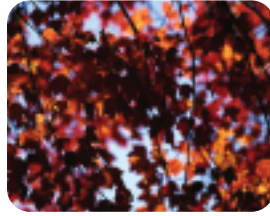
## Central and Eastern European banking: European Union accession and other issues *continued...*

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operations in the medium-term.  
Those banks looking to diversify into the economies most likely to profit in the next global bull market need look no further than CEE.



Each month the 'Doing business' guides focus on a different country, providing an up to the minute look at what it means to do business there. The guide provides a detailed view of a country's business environment, foreign investment and trade opportunities, its regulatory environment, labour practices, financial system and tax laws. Visit [www.pwc.com/doingbusiness](http://www.pwc.com/doingbusiness) for further information.



# Customer relationship management: transforming the retail banking industry

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by Andy Elliott and Michele McLaughlin



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Banks are still trying to understand their customers better. Customer relationship management (or CRM) is central to achieving organic growth and keeping customers happy. Much has been invested by the banking industry in developing CRM tools, but the returns achieved to date have not yet been those sought. The issue, perhaps, is that CRM tools alone are not the answer: the key is using these tools to underpin changes to customer focused processes and behaviour, and so develop more profitable customer relationships.

Understanding your customers and what they want from your organisation is challenging, particularly when they interact with banks in such a disjointed fashion and through multiple departments within any bank. Within a typical retail bank these contact points can include customer service (e.g. call centres), treasury services, internet banking, personal bankers, asset management, real estate services, card services and mortgage banking. Further complications arise because customers can be defined and viewed by banks as an account, as an individual (with multiple accounts) or grouped as a household. It can be a significant challenge just to define what is considered to be a 'customer' within an organisation.

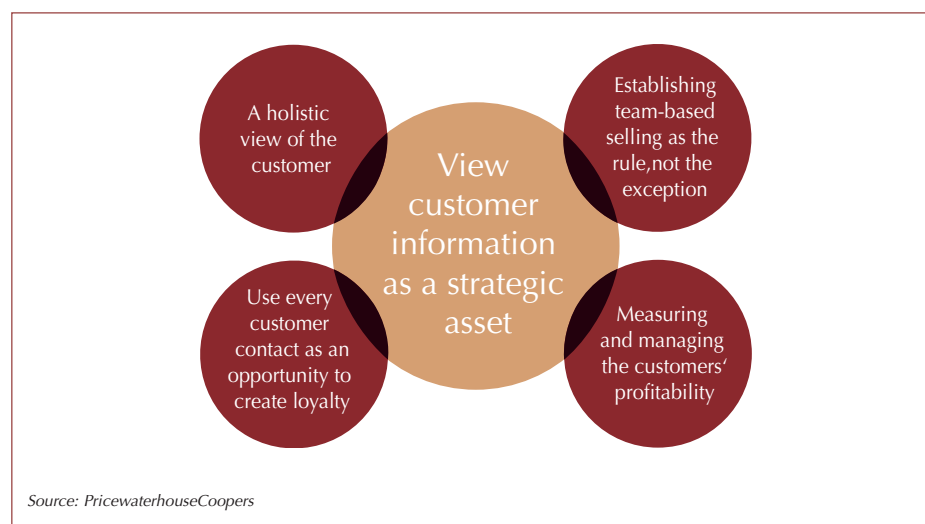
### CRM Defined

There are a number of different definitions for CRM. A common one, that seems relatively straightforward, is a business strategy that includes the technologies, applications, processes and organisational changes to optimise profitability, revenue and customer satisfaction for your customers. In other words, an organisation's sales, marketing and customer service activities.

CRM, at its heart, is about creating a customer centric business model (from the product lead models previously

commonplace) in efforts to know customers better and respond to their needs in a more predictive manner.

The competitive landscape demands that banks gain a better understanding of their customers' needs and, using that information, offer them superior service. CRM will continue to be a key driver for banks, and the organisation and processes supporting efforts in this area will continue to evolve. Banks will need to pursue CRM developments aggressively, while managing the related risks and costs along the way.



# Customer relationship management: transforming the retail banking industry *continued...*

## CRM Trends

Retail banking is becoming increasingly competitive with banks continually seeking to enhance their sales, marketing and service operations in order to create and capitalise on cross-selling opportunities. Some of the most significant current CRM trends are outlined in the table below.

Many organisations continue to make substantial investments in CRM initiatives and tools, and view CRM as imperative to achieving their business objectives. This is supported by a survey of US based retail banking organisations, where respondents highlighted customer retention/loyalty, profit growth and customer satisfaction as their three top priorities (see Figure 1).

To remain competitive, organisations know that they need to take advantage of their size and customer base to reap potential expected benefits of cross-selling and better serve customers across multiple, internal lines of businesses. As banks have expanded their product base and geographical reach, efforts to integrate business processes and systems have been the main focus.

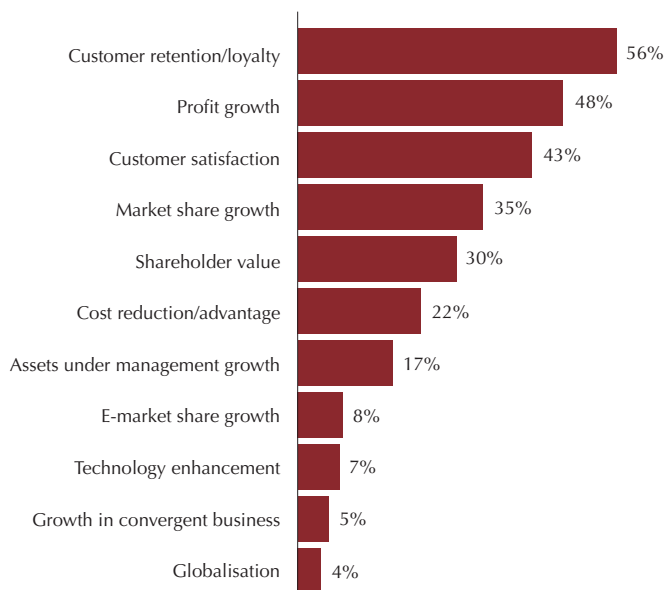
**Key CRM Trends**

- Customer-centric marketing, rather than marketing of products/services
- Calculating or aggregating customer profitability at the individual customer level, customer segment and business relationship level, instead of just immediate household or individual account level
- Using a bottom-up approach, that incorporates transaction-level detail, to calculate customer profitability to pinpoint more accurately profitable/unprofitable customers
- Sales teams supporting broader service and product ranges
- Tailored bundling of products for customers
- Increasingly consultative cross-selling in the call/contact centres, and team based selling
- Cross-selling strategy being better communicated throughout the organisation and reflected in resource allocation and organisational structure
- Consistent branding being built and maintained across all sales channels to minimise channel conflict
- Propositions being targeted and customers offered a product or service that they are more likely to buy, through their preferred interaction channel(s)
- Increasing sales-based incentive programmes for customer-facing staff
- Using account maintenance and servicing contact as an opportunity for sales
- Web and telephony infrastructure increasingly being used to interact with customers, as customer habits and preferences change
- More use of self-service by customers

Yet it appears that many organisations have had limited success in exploiting the promise of enterprise-wide CRM programmes due to the complexity of their internal structures and difficult economic and market conditions. As such, many banks have instead chosen to perform smaller CRM projects that addressed an individual division or business unit. In PricewaterhouseCoopers' survey, one leading retail bank indicated that its business lines continue to operate in a silo mentality. Each works with their own CRM initiatives, although they do work together for client targeting purposes, and they leverage each other's client base information. Another leading retail bank indicated that its business lines still approach CRM independently and while they are working towards a more holistic customer approach, right now that is still considered to be a "vision of utopia". These responses were common in relation to CRM initiatives being undertaken by several large global retail banks.



**Figure 1: CRM priorities**



Source: Peppers and Rogers, *The practice of CRM in the financial services industry*, Feb 2001.

Many retail banking groups have a high number of disparate systems that must be successfully integrated within any CRM solution. Additionally, they often find significant duplication means that key data elements maintained on these systems are redundant within the organisation; for example, many banks have large initiatives just to come up with common customer, employee, business partner and product/service codes before they can begin to implement an effective CRM solution.

For many banks 2000-2002 have been the years for implementing the foundations (e.g. integration, middleware, data centres, etc.) on which their CRM solution can now be built.

### Mixed results to date

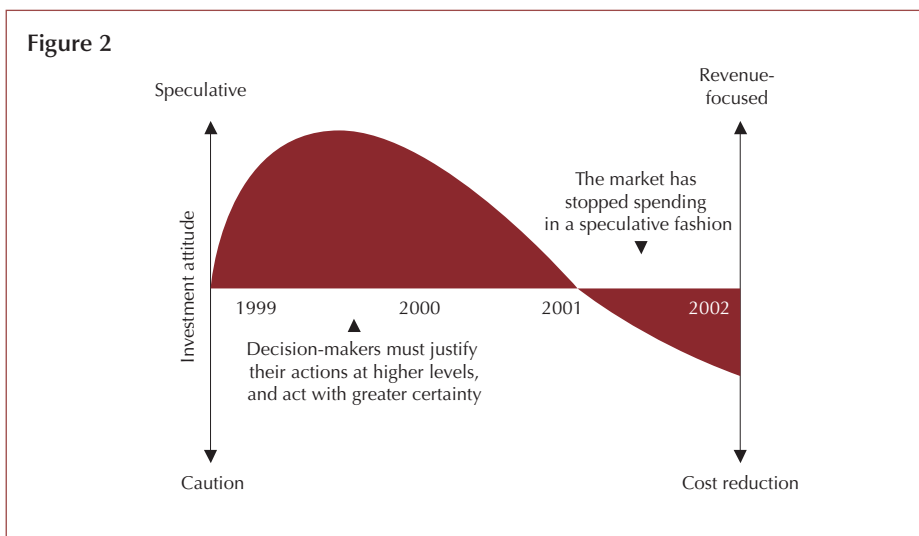
There are many reasons why CRM initiatives in the banking industry have had mixed results to date. 2001 and 2002 will be remembered as particularly difficult years, with many organisations deciding to delay

their CRM projects or divide them into smaller component pieces, reflecting the complexity and scale of integration requirements needed for any enterprise-wide CRM initiative. Many banks appeared simply to have taken on too large a challenge in one go.

In addition there also appeared to be general confusion regarding whether CRM was, or should be, a primarily IT-focused initiative, or part of a wider change within the organisations. Management lacked a clear understanding of how CRM would impact its organisation and the risks related to undertaking such a project, and often remained sceptical until success stories within the industry made a stronger case for launching complex, costly CRM projects.

Significant IT cutbacks and increased economic and market pressures in 2001 and 2002 also meant that organisations refocused on the short-term performance of their core businesses, and limited what they considered to be discretionary spending. In that environment the projects with significant IT spend components were often more closely evaluated against their 'bottom-line,' profit-enhancing potential, leading many banks to concentrate more on cost reduction initiatives with a closer correlation to higher profits (see Figure 2).

# Customer relationship management: transforming the retail banking industry *continued...*



above 2001 spending. While this growth may partially reflect investment deferred as a result of potential Year 2000 issues it is significant nonetheless.

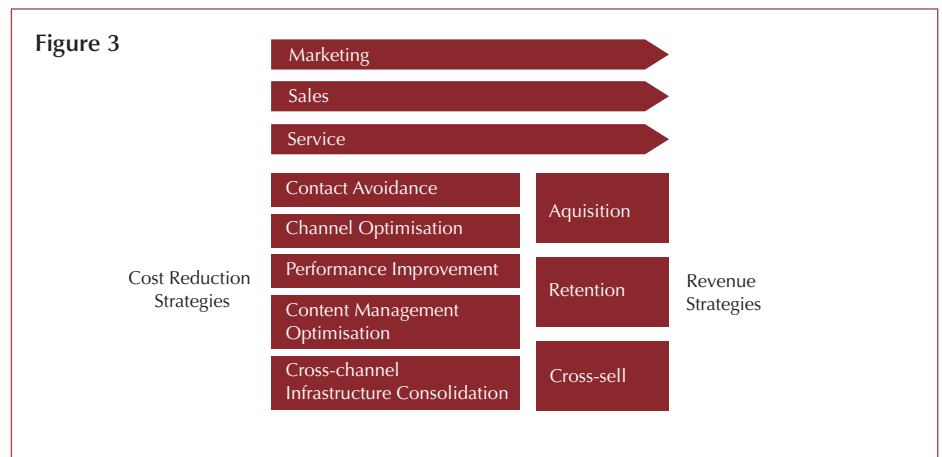
The levels of ongoing CRM spend vary enormously between organisations: it appears that some are spending as much on CRM maintenance activities as they are on CRM development activities, while others, on the opposite extreme, indicated that at a corporate level no direct CRM costs have yet been incurred, except for headcount expenditure for the oversight group. It is clear, in any event, that CRM projects are a significant investment with one bank indicating to us that it has budgeted over \$50m on more than 50 different projects and another bank outlining that it has spent well over \$10m on CRM related systems implementation alone.

CRM projects typically incorporate both cost reduction and revenue enhancing strategy components (see Figure 3).

Revenue enhancing projects tend to be more speculative, for example, if the efficiency of a sales process is enhanced, sales people will have more time to drive sales and therefore, one might assume, increase sales levels. However, these are sometimes difficult assumptions to make and justify in an economic downturn when customers are simply not investing or buying for other reasons.

Despite the recent economic challenges the focus on CRM projects continues to grow on the basis that they will help drive future growth within organisations.

Many leading analysts indicated that CRM spending rose in 2001 between 40–50% above the spending year 2000, and that growth in 2002 was between 20-30%





## Detailed CRM goals vary considerably

CRM goals vary between different banking organisations. A number of leading banking institutions in the US and Europe were surveyed by PricewaterhouseCoopers to establish what management was hoping to

accomplish from their existing CRM projects (see figure 4). The responses received were varied, but the overall sentiment correlated to the CRM priorities identified earlier.

Many retail banks have been running CRM projects, without having formally defined

them as such. Additionally, many initiatives have tended to involve a division or sector of the bank, but not usually the entire enterprise. It appears that many banks are, however, now beginning to start enterprise-wide initiatives.

## Benefits

One of the most significant benefits sought from CRM initiatives is the better identification and segregation of profitable and non-profitable customers. Other benefits sought include customer lifetime value analytics, developing more effective pricing strategies, enhancing revenue and improving customer service, and proactively managing churn and growth by identifying targets for acquisition and retention as well as those to cede to competitors.

Household analysis, using and elaborating on individual customer information, also allows banks to use fact-based strategies to more effectively interact with and serve customers. Banks are also expecting that their CRM developments will allow them to better identify and focus on customer channel strategies, for example through the use of non-invasive marketing efforts.

**Figure 4: Detailed CRM goals**

- “Our goal at this point is to enable our people to know their customer. We want to get the information out of our people’s heads and Palms’ and into our CRM system, so that everyone in our business who touches our clients will be in touch with our clients’ likes, dislikes and preferences (e.g. birthday, sports teams, hobbies, investment choices, etc.).”
- “Cross Sell; we have the opportunity to identify and segment our most valuable customer and almost predict their needs.”
- “Our goal of CRM is as follows: first is service enhancement, second is cost enhancement and we expect that the logical by-product of these efforts will be sales enhancement.”
- “One of our goals is to move from individual business line CRM initiatives to a centrally managed initiative, but before we make that move it has to make sense, we are not convinced that it makes sense yet.”
- “We are working towards building a complete and comprehensive firm-wide customer data warehouse, all business units, all products.”
- “Longer term we want our systems to be smart. Right now we have the ability to determine the call centre level of priority that a customer will be given based upon their account number. The possibilities and opportunities to be smart and proactive to our customers needs are endless.”
- “We are incorporating Six Sigma into our CRM business process enhancements, in an effort to maximise the value of our dollar expenditure and end results to our firm and clients.”  
*(Six Sigma is a methodology that provides businesses with the tools to improve their business processes. By bringing a Six Sigma emphasis into the CRM project, the retail bank can focus on increasing performance and decreasing process variations thereby leading to error reduction and improvement in profits, employee morale and quality of products and services.)*

# Customer relationship management: transforming the retail banking industry *continued...*

## CRM transformation risks

CRM centres around customer interactions in order to maximise the lifetime value of customer relationships. In order to benefit most, banks must successfully achieve all the process and behavioural changes that CRM entails. This in turn is reliant upon changing and leveraging information technology to make organisational, process, and system enhancements within their sales, marketing and customer service functions. These changes bring additional risks to the organisation that must be addressed by management (see Figure 5).

Clearly change risk management is extremely important: the functions that any CRM initiative touches – sales, marketing and customer service are inherently sensitive, because they are so visible and closely linked to customers. They are externally facing and directly impact sales, revenues, company reputation, and customer loyalty, providing a strong business case for proper change risk management.

Two specific types of risk have been identified and defined in the context of CRM initiatives: downside risk (the risk of negative things occurring that are not anticipated) and upside opportunity risk (the risk that good things will not happen and that the expected benefits will not be realised).

Figure 5: Transformation risks

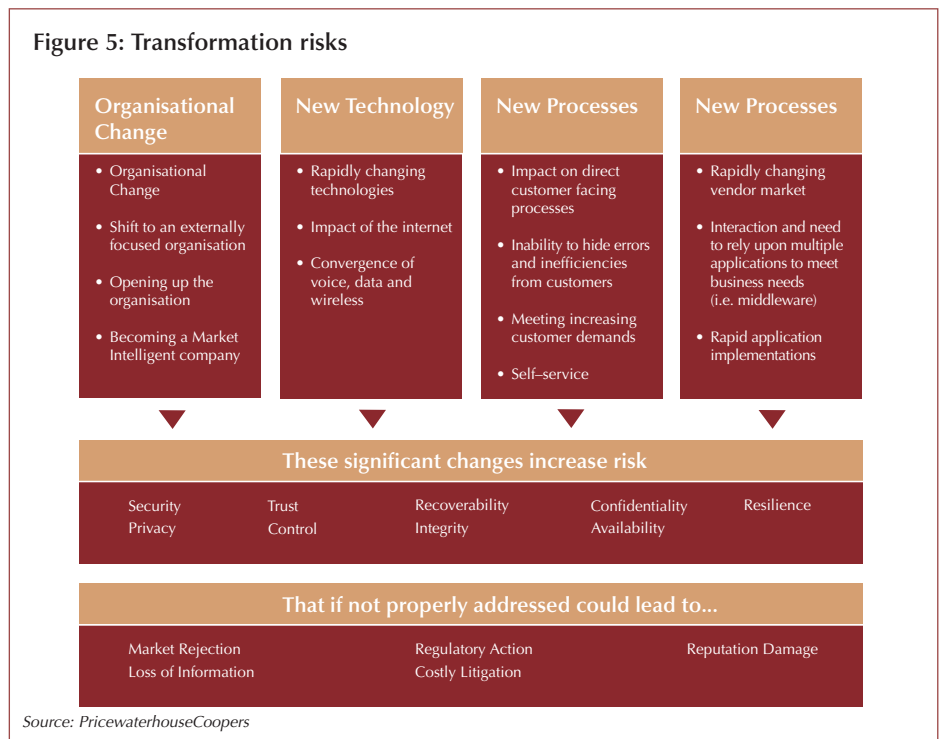
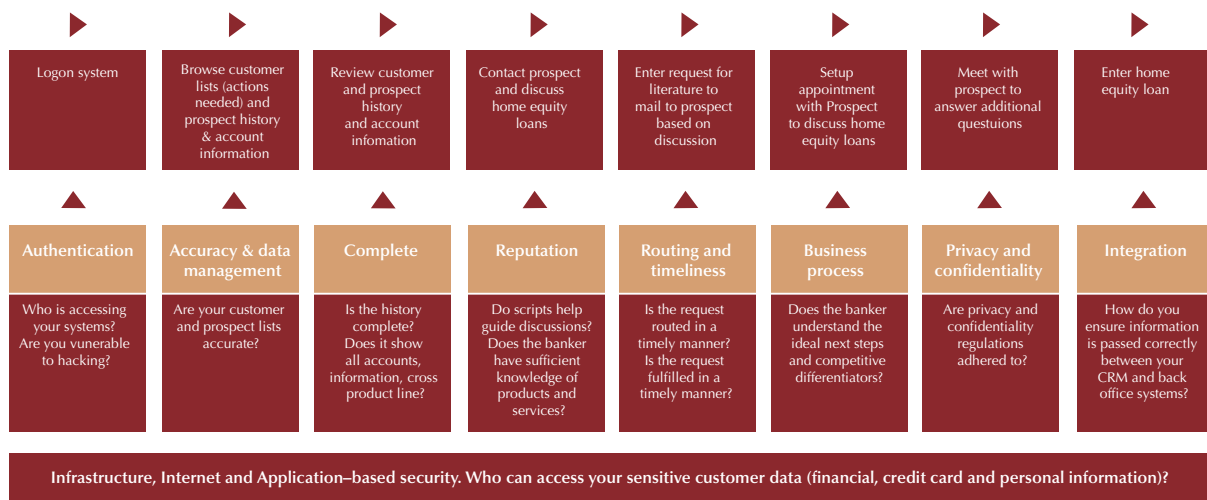


Figure 6: Examples of typical downside risks:

- Lack of employee loyalty
- Declining customer satisfaction and service levels
- Abused privileges because of segregation of duties issues
- Privacy, theft and fraud
- Inaccurate information and data
- Non-compliance with laws and regulations
- Service interruptions
- Inaccurate or unavailable website content
- Telecommunications abuse or toll fraud within the call centre
- Call centre staffing issues
- Behavioural/psychological changes and patterns
- System integration issues
- Lack of flexible pricing for customers



Figure 7: Key elements of a typical CRM component process



Examples of upside opportunity risk that must be managed to accomplish the business objectives of any CRM initiative include misdirected marketing campaigns, lowering marketing return on investment, eroding customer loyalty or decreasing market share, replacement of high margin items to commodity based items in the sales mix, low conversion rates on opportunities, inability to effectively up-sell or cross-sell products and services, and lost revenues due to the unexpected inability to anticipate customer needs.

### Key Aspects of Successful CRM Programmes

In order to build a successful CRM programme, organisations must recognise that effective CRM is a combination of strategy, process, people, technology and data. It is not just all about technology. CRM vision and strategy should be created before implementing any specific CRM tool, because while CRM projects have often started as IT projects, the initiative must cross the entire business spectrum of an entity for the business to maximise the benefits achieved.

It is also vital that senior management supports any CRM project, with direction coming from the top. There should be an all-encompassing strategy and recognition that no one department alone can drive the cross-functional process changes required. In addition organisational changes can spark employee concern over job security, job responsibilities, career development, department operations and so on. The more significant the changes, the more impact they will have on employees, and the greater the need for management to plan and initiate both organisation re-design and change management projects to support the CRM initiative.

# Customer relationship management: transforming the retail banking industry *continued...*

Another key element is the need to break the CRM effort into multiple projects that will provide quick wins for the organisation at an acceptable level of risk and at an acceptable tolerance level for change.

The integration of data to provide the foundation for CRM solutions can be highly complex. Most companies find they have multiple customer data stores per segment, each of which contains inconsistent definitions of the customer, different or duplicate labels for the same individual, and inconsistencies with other household, order or structural features of the data. To truly understand customers better, this data must be integrated so that customer information and cumulative and complete interactions can be shared within and between an organisation's sales, marketing and service operations. Management can then move towards proactively managing personalised customer interactions to provide differentiated services, up-selling and improved cross-selling, regardless of channel. From there management can also try to develop a clearer understanding of individual customer behaviours and the associated contribution of profit.

In order to achieve the effective integration and management of data, organisations typically must choose multiple systems vendors to best suit the needs of the CRM project. Often no one

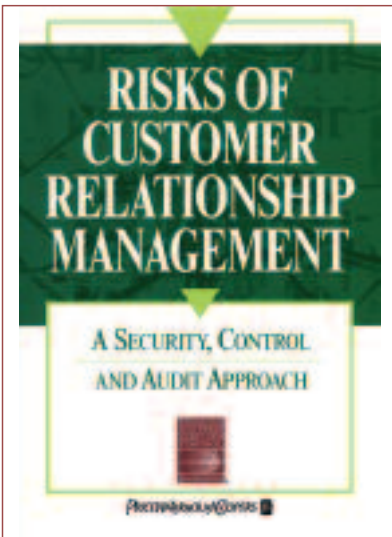
vendor provides all the systems that a successful CRM strategy requires; instead companies must patch together the available systems to fit their strategies. New CRM technologies are being introduced approximately every 18 months and the leading products and vendors today will not necessarily be the leaders in 18 months. This in itself is not necessarily an issue, however, if CRM requirements are properly specified at the outset. The implementation team must have sufficient knowledge and expertise of the technologies used more widely to support the changed, CRM-focused business model (i.e. voice response, wireless, internet, kiosks, handhelds (PDAs), CTI/telephony, etc.).

Finally, with a variety of systems and support requirements, any CRM solution must embed end-to-end data and information security. Security and privacy can be compromised at any point from individuals within and outside an organisation; and the potential consequences of any such breach could be severe.

## Conclusion

IT-focused CRM ventures have proved to be costly for the banking industry. Successful implementation of CRM requires recognition that change processes on this scale will continue to pose challenges to management

but are critical if business operations are to be increasingly transformed toward greater and more effective customer centricity. Investing in CRM programmes will allow organisations to remain competitive. Effective risk management throughout the transformation process is critical if management is to protect the value of those investments, navigate the myriad of challenges and ensure benefits are achieved and returns on investment made are maximised.



For further reading on CRM and related risk management topics please refer to *Risks of Customer Relationship Management (CRM) – A Security, Control and Audit Approach*, published in March 2003 by PricewaterhouseCoopers and Information Systems Audit and Control Foundation® (ISACF®). The book illustrates how CRM initiatives can help companies attain enterprise-wide goals and describes the technology involved. It also explores the impact risk management and assurance professionals can have on ensuring successful CRM initiatives by addressing tactical issues during the transformation process.

# Market transparency – the need for better external reporting of risks and controls

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by Sam Dibb, Chris Thompson and John Parkhouse



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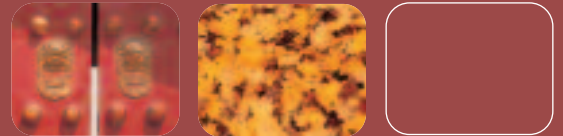
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The needs of financial market participants and regulators for market transparency are extending beyond the realms of trading, pricing and financial information into areas of risk and control, and a framework is now required within which these needs can be met.

### Why transparency over risks and controls?

Most people associate the term 'transparency', when applied to financial markets, with the availability of trading and pricing information from exchanges and OTC markets, and also with the financial and business information that companies make available to investors and other stakeholders. Such transparency facilitates the operation of free and competitive markets and the fair treatment of customers and investors. The benefits and overall public good of market transparency in this context are broadly understood and accepted and are generally enforced by law or regulation. However, analysis of the institutional arrangements in financial markets highlights the need for similar discipline around the risks that market participants face and the controls that these organisations put in place to manage these risks.

Importantly, the connected and inter-dependent nature of capital markets means that it is not possible for any one organisation to look at its risks and controls in isolation, it also needs to assess the impact of relationships with customers, service providers and other counterparties. For example, a hedge fund will typically have a prime broker and a global custodian. Analysis of the risks that the hedge fund faces must include assessment of how these critical relationships are monitored and managed. As part of this process, the risks and controls at the prime broker and custodian must be actively considered.

Third party service provider arrangements are already commonplace in many areas and are increasing in range and scope across financial services organisations. Outsourced activities and controls often include those which have significant impact on financial and other externally reported information. In addition, there are certain areas where the supply of a particular critical service to all market participants is limited to one or a few key providers, for example exchanges and other trading networks, central securities depositories and clearing and payment systems.

### Why now?

There are a number of important recent developments that reinforce the need for greater transparency over risks and controls incurred indirectly through third parties. Perhaps most prominently, the collapse at Enron and other corporate failures vividly illustrate the need for sound governance, which cannot function unless managers and directors of companies understand the risks their businesses face and the controls in place to address those risks. The Sarbanes-Oxley Act, which seeks to address some of these issues, requires senior executives to attest to the suitability and effectiveness of controls designed to ensure the accuracy of their organisation's financial statements. It is hard to envisage many executives willingly giving such attestation, with the very evident personal risks entailed, unless they have a strong assurance that all processes and systems operated for them or their clients by third parties are also subject to effective internal controls.

The January 2003 Group of Thirty report *Global Clearing and Settlement – A Plan of Action*<sup>1</sup> highlights the need for providers of securities processing services to make transparent the means by which

1. The executive summary of the G30 report and a PricewaterhouseCoopers briefing paper outlining its impact and key considerations, as well as the actions for individual organisations, can be found at [www.pwcglobal/financialservices](http://www.pwcglobal/financialservices). The full report is available from the Group of Thirty, [www.group30.org](http://www.group30.org), at a cost of \$60.

# Market transparency – the need for better external reporting of risks and controls *continued...*



For example, the Australian Stock Exchange’s recent recommendations on corporate governance principles include a system of risk oversight, management and internal control designed to enable companies to inform shareholders of material changes to their risk profile.<sup>2</sup>

Elsewhere, in an effort to further enhance the regulatory environment in Luxembourg and the related transparency of fund operations, it will now be required for each fund to engage its auditor to submit a ‘long-form’ report to the authorities which will assess and describe in detail the operations, controls and procedures surrounding the fund and all its service providers. The regulation specifically provides for the use of SAS 70 or similar reports to facilitate production of this long-form report.

they control and mitigate the financial, operational and legal risks to which their customers may in turn be exposed. Market discipline, arising from greater focus on the quality and relevance of information an organisation makes available to the markets, is a pillar of the proposed Basel II framework, and caveat emptor remains a deeply enshrined principle in most markets, yet neither is effective without relevant and reliable risk information being available to counterparties and customers.

Other developments are creating further impetus for change in specific jurisdictions.

Luxembourg is a jurisdiction whose primary financial services business is the servicing of investment funds – often remotely from the fund’s promoter. The introduction of this regulation is, surprisingly in today’s environment of cost reduction, seen by many organisations as a positive step towards providing transparency and an independent assessment of what is actually happening. The additional cost and administrative burden associated with it is seen as a small price to pay to provide such clarity.

Individually, each of these developments offers convincing reasons for management to

seek assurance over processes and controls operated by third party service providers. Collectively, they present a compelling case.

## A framework for transparency of risks and controls

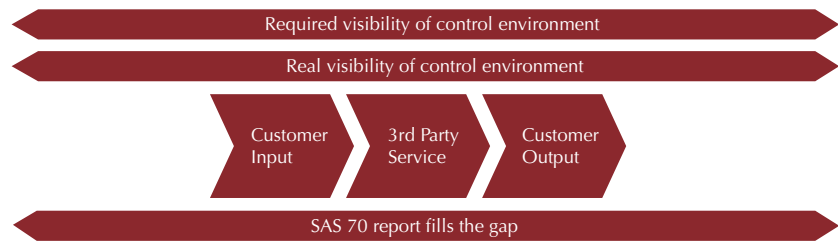
There are two broad approaches whereby users of a service can gain assurance that the service provider’s processes and controls operate effectively. The first option would be for the users themselves to directly review the service provider’s operations. For a number of reasons this is generally impractical, the most obvious being that most suppliers have many customers and a succession of similar and duplicative reviews would be time consuming, wasteful and uneconomic.

A more efficient option would be for the service provider to detail in a report its control framework, systems and processes and to make this information available to its customers. For this to have credibility there needs to be independent review and testing of the service provider’s report. The latter approach is, in our view, clearly the direction in which the market should head. Indeed, many leading organisations already provide assurance of this type but are actively working to improve the quality of controls that they have and the means by which they demonstrate this to customers. Others have further to go.

2. ASX Corporate Governance Council, Principles of Good Corporate Governance and Best Practice Recommendations, March 2003.



The purpose of a SAS 70 report is to enable the management of a service provider's customers to understand the control environment in place and ensure that their own operations include complementary and sufficient controls to mitigate any weaknesses in that environment. This concept is illustrated by the diagram:



The first stage in the development of an effective internal control reporting framework is a "stakeholder analysis" to establish a clear understanding of the obligations of the service provider to various stakeholders, typically including customers, regulators and auditors. This is not necessarily limited to specific contractual obligations in delivery of a service but often also covers non-contractual requirements and expectations, for example those that might provide competitive advantage.

The core of any controls (or SAS 70) report is the service provider's own

Internal Control Policy as this document encapsulates how the organisation controls risks and ensures compliance with various rules associated with delivering its services. The systems and operational elements that make up the scope of the controls report should function in compliance with the Internal Control Policy and its focus should meet the needs of all stakeholders.

The Internal Control Policy will be supported by a number of control objectives on how the policy is achieved operationally together with a series of key control processes that are

completed to demonstrate that specific actions are undertaken to achieve all the control objectives. In preparing the report an independent accountant reviews actual operational procedures against this framework of controls to provide assurance that those controls were in place and were operating effectively. Reports typically cover a specified period but can be given at a point in time, particularly where the service provider has just commenced delivery of a service and hence there is little or no track record.

Notwithstanding any minimum threshold that may be imposed by regulators, we consider that those organisations with foresight see the ability to offer sound and verified controls as an increasingly important differentiator from their competitors in winning

business, as is already the case in fund custody businesses.

Transparent risk and control reporting by vendors is not a panacea for users of services and should be viewed as complementary, rather than as an

alternative, to other important control processes that they might operate. Sound vendor management and strong internal controls, particularly around the interaction points with service providers, remain vital components of a sound overall control environment.

# Market transparency – the need for better external reporting of risks and controls *continued...*

An organisation’s vendor management programme should identify the risks associated with the service being provided and ensure that the organisation has adequate and appropriate processes in place to monitor and control those risks including, but not limited to, monitoring of reports prepared by the service provider.

## Evolving and leading practice

Today, many service providers to the financial services industry utilise a SAS 70 or similar type of report as the way to transparently report the design and operating effectiveness of their internal controls. SAS 70 is a US auditing standard that is increasingly recognised globally and provides a framework that allows the service provider to customise its internal controls reporting for its particular circumstances. Similar standards exist in some other markets, such as FRAG 21 in the UK. In such reports, the management of service providers details the procedures it has in place to meet specified control objectives, and independent reporting accountants then test the operation of these procedures on a sample basis over a defined timeframe.

SAS 70 type controls reports are particularly well suited to service providers who perform transaction processing or record keeping services, or who provide the technology environment supporting

a transaction processing environment. New standards of internal controls reporting are also emerging for service providers who want to provide comfort with respect to other activities, such as the security, confidentiality, privacy and resilience of the service provider’s technology environment.

In areas where SAS 70 reports are already common, the scope of the reports may

need to be expanded to meet the broadening requirements of users. Users care about a broader range of controls than those related directly to financial statements, which is where the current report tends to focus. A service provider’s ability to continue in business and be resilient to shocks and disasters is clearly critical to organisations that rely on those services, and an obvious example of an area where third party assurance

**Impact on organisations:**

<b>Users</b>	Those that rely on procedures operated by third parties need to make sure that they have strong evidence that these procedures are effective. Audit committees should specifically evaluate this risk and executives required to attest to the effectiveness of an organisation’s controls should ensure that they have unambiguous assurance that controls operated by third parties are sufficiently robust and demonstrable to support such a statement. This should complement and add to the vendor management and process interaction controls that the users operate themselves.
<b>Service Providers</b>	Organisations that supply services such as custody, record keeping, transaction processing and information technology should be prepared to provide customers with transparent controls reporting. They should also evaluate how they will fare in an environment where having a robust control framework becomes increasingly a matter of competitive advantage, as well as a compliance issue. Waiting for customers to ask for information is risky. If independent testing of controls reveals weaknesses then reporting this to customers may well have an adverse impact on those relationships. It is much better to anticipate the need, robustly test controls in advance and remedy any weaknesses (in substance or demonstrability) that may exist and then be able to report an improved control environment to customers.



is needed. Alongside the need to evaluate and address people-related aspects of operational resilience, the parallel need to consider and take steps to address reliance on third parties was one of the key lessons learned from September 11.

SAS 70 and other control reports have historically been issued on an annual basis in most cases. However, there is a recent trend towards service providers producing these reports on a more frequent, typically semi-annual, basis. In the future the reporting frequency may well synchronise with the reporting requirements of public companies. For example, those listed in the US are required to submit quarterly filings (in accordance with Sarbanes-Oxley Section 302) with respect to the accuracy of financial reporting and related internal controls effectiveness and that market discipline is being considered in other jurisdictions, notably the European Union.

Currently, SAS 70 style reports are primarily designed to meet the needs of, and are addressed to, the auditors of the service provider's users. However, regulatory developments, as well as governance and risk management best practice demand that the scope of such reporting be broadened to meet the needs of a wider audience and in particular the management, directors and shareholders

*"We are living in an era where the reliability of operational processes is attracting heightened interest on the part of our client base. The independent assessments performed by PricewaterhouseCoopers' SAS 70 reviews play an important role in providing our clients with a consistent picture of our operational controls."*

David Weisbrod, JP Morgan Chase Investor Services

of the users. Addressing this broader audience will also allow service providers to use such reports as part of their marketing – competing on the basis of sound controls as well as traditional factors such as cost. To some degree SAS 70 style reports have already evolved to meet this need but there is a need for further development of standards and reporting practices to make sure that this is done in a consistent and appropriate manner.

### Who is affected and what should they do?

Although regulators have yet to issue any detailed guidance in this area it is hard to see how the responsibilities of management (either in terms of general stewardship or from laws such as the Sarbanes-Oxley Act) can be fully met without some form of third party assurance. The article in this journal entitled "New – and non-traditional survival strategies for financial services firms" describes developments in

connection with outsourcing and business transformation and it demonstrates that use of service providers is a trend that will only increase in banking and capital markets, therefore assurance over such services is a critical component of sound governance and an effective control environment. In addition, conversations with prudential supervisors in a number of jurisdictions indicate that information provided in SAS 70 and similar reports is increasingly considered in risk-based regulatory evaluations.

Consequently, this issue affects virtually every organisation operating in the financial markets.

As with many developments of this type, there is often an instinct to wait and see what peer and competitor organisations do before taking action. This creates an opportunity for organisations wishing to secure competitive advantage to act now and be viewed as leaders in an environment where sound governance and control is increasingly high on the agenda.

# Wealth management – where to next?

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by Johannes Grosskopf, David Newton and Salman Ahmed



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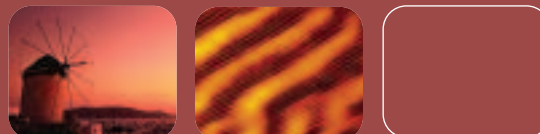
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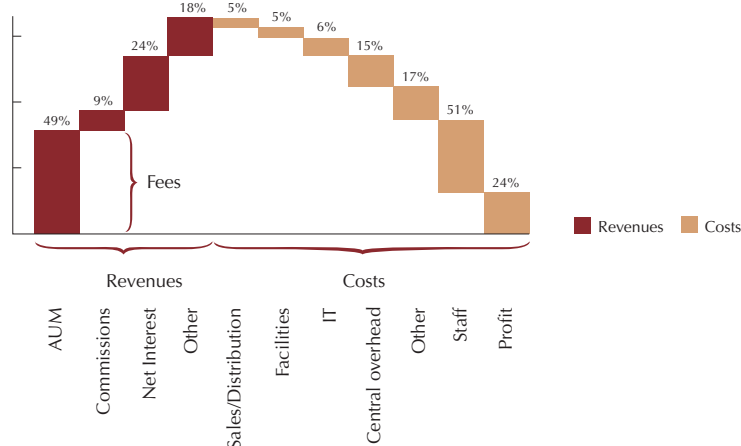
The dramatic fall of most international equity markets is changing the relationship between private bankers and their clients. Whilst this is proving painful for private banks in the short term, there is hope for those private banks agile enough to change so that they meet the new challenges. We explore below how private banks are re-evaluating and changing aspects of their traditional business models and aiming to win the coveted ‘trusted advisor’ status. We also review the effect that external pressures are having on the offshore centres and what private banks’ responses have been.

### The background

The profitability of private banks, like most other financial institutions, has fallen dramatically over the last two years. Our research shows that two-thirds of private banks in Europe and the UK have cost income ratios in excess of 90%, a significant increase from two years ago.

The reasons for deteriorating profitability in the private banking sector have been fourfold:

Figure 1: Revenue and cost sources in private banks



Source: PricewaterhouseCoopers

- Revenues are still largely linked to assets under management (‘AuM’) which have fallen dramatically, coupled with a reduction in fee margins
- Transaction fees have suffered due to the lack of activity on accounts
- Interest margins are at their lowest levels for many years
- Increased costs due to regulation, compliance and the requirement for increased controls/reporting

PricewaterhouseCoopers’ 2002 North American Private Banking/Wealth

Management survey demonstrated clearly the reliance of private banks on fees linked to AuM and transaction levels. As illustrated in Figure 1, 49% of the revenues of North American private banks were still generated by AuM levels, 9% by transaction/commission and 24% by net interest margins. All of these drivers of revenues have been hit by adverse market conditions. The demand for transaction-related services has been low because clients, who have invested heavily in equities, have changed their preferences and have moved into cash and other capital preservation products.

# Wealth management – where to next? *continued...*

The low interest environment has also highlighted those businesses, especially offshore bank and trust companies, which have been over reliant on their deposit bases (in many cases free funds) to subsidise their core businesses which have not been profitable.

On the cost side, the picture does not change.

In figures not dissimilar to those in the PricewaterhouseCoopers European Private Banking/Wealth Management survey, our North American survey showed that in 2001/02 staff costs made up 51% of total expenses, with the remainder being split between IT, central overheads and infrastructure costs.

Cutting the cost base is difficult for private banks where relationships are so critical. Private banks have therefore been unable to reduce their front office private bankers significantly due to the existing client relationships which might be lost if the private bankers were made redundant or client contact reduced. Indeed, in volatile markets more contact is required rather than less. As a result, costs have not reduced proportionally in comparison with the falling revenues, with a resultant increase in the cost/income ratios.



## Changing private banking business models

Given these challenges, what is it that those who are profitable or who want to be profitable are doing and where should management’s focus be?

In addition to focusing on profitability management needs to focus on the 5 areas outlined in Figure 2.

As result of the rising cost/income levels and changing customer preferences, management teams are investigating how to change their old product and distribution models and are focusing on two issues in particular:

### • Outsourcing

Private banks’ processes and systems have been exposed in many cases as archaic and inefficient, and banks are increasingly reviewing outsourcing opportunities in order to optimise operational efficiency.

### • Distribution/Manufacture

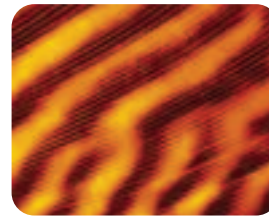
Private banks are also determining whether they want to be manufacturers of products or distributors and are either outsourcing the manufacturing, or changing to an open product architecture model.

Also important are the external pressures on the offshore centres where, traditionally, a large portion of private banking assets have flowed to/from.

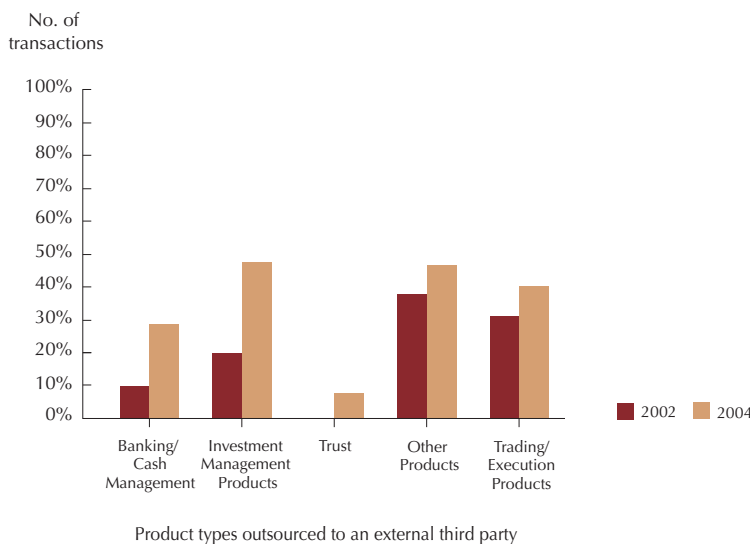
Long-term success will depend on a private bank’s ability to segment its client base and offer appropriate products to the correct segment, as well as the bank’s continued compliance with ever increasing regulatory pressure.

### Providing core services and outsourcing non-core

The private banking industry reflects a number of different business models ranging from the traditional ‘Swiss private banks’, investment banks and retail banks offering more sophisticated products to their affluent



**Figure 3 Providing core services and outsourcing non-core**



Source: PricewaterhouseCoopers

customers, to brokers and fund managers. More recently there have also been a number of new entrants and joint ventures aiming to capitalise on their existing brands and/or distribution networks. Most of these models, however, had one theme in common: the private bank would manufacture its own products and distribute these products to the bank's existing customer base. This concept has been under attack for a number of years but the dramatic fall in markets has led to clients themselves challenging private banks as to whether it is still optimal. The 'trusted advisor model' is based almost exclusively on providing 'best of breed' products and services.

Many private banks are now outsourcing core and non-core products, and it is evident that the transition is not easy or straightforward. As indicated by the respondents to our 2001/02 North American survey, even more banks will be following suit in future. For example, many private banks already outsource basic banking and custody services to retail providers, either by white labelling the insourced product or by joint branding. It is interesting to note that 44% of the respondents thought they would be outsourcing the manufacture of investment management products to third parties. The main reason for outsourcing is cost reduction because private banks do

not always have the necessary scale to provide all the products required by their clients profitably.

However, the benefits from outsourcing are not cost savings alone; private banks are increasingly focusing on those areas where they believe they would be able to differentiate themselves and outsourcing those areas where they believe others have better products/services (at a cost effective price).

### Open product architecture

The private banks adopting open product architecture now face two problems: how to keep their clients and how to maintain revenue levels when they have to share revenues with product providers.

Those private banks who have embraced open product architecture would want their clients to believe that to be the 'trusted advisor' it is a requirement to provide clients with best of breed products. However, these private banks are increasingly finding that their clients are starting to question the value added by their relationship manager and as a consequence what level of fees they are prepared to pay. Clients are becoming more sophisticated and depend upon their private banks for wealth management advice, not simply a pure equity management service.

## Wealth management – where to next? *continued...*

Adopting the open product route will have a significant impact on a bank's revenue line, and it is critical that the costs previously linked to such activity are cut appropriately at the same time. Those who provide the products will continue to demand their prices and private banks will have to re-work their pricing models to calculate what fees they can legitimately request from clients on top of the 'manufacturing' cost being charged by the product provider.

It is likely that only those private banks that can consistently provide their clients with good advice and win 'trusted advisor' status will be successful in this model. Otherwise clients will increasingly manage their own affairs, leaving private banks for the equivalent open architecture products from retail providers and fund supermarkets at a much reduced price.

### External pressures, outside the control of private banks

While facing issues concerning which business model will be most profitable in future, private banks also have to deal with external issues, particularly in the offshore markets (OFCs).

During the last few years a number of OFCs have suffered through a loss of business and/or reputationally. The cost of doing business in the OFCs has risen

substantially, largely due to increased regulatory oversight costs, and a number of businesses are reviewing how to consolidate their operations in the OFCs or whether to continue at all.

Two of these external pressures, tax and the Organisation for Economic Co-operation and Development (OECD), are increasingly changing the way in which OFCs will be used in future. To further illustrate the point we focus later in this article on the experiences of one OFC, Bahrain, which, amidst all the political and international pressures in the Middle East, is positioning itself for growth as an offshore centre.

### Tax harmonisation and the EU Savings Directive

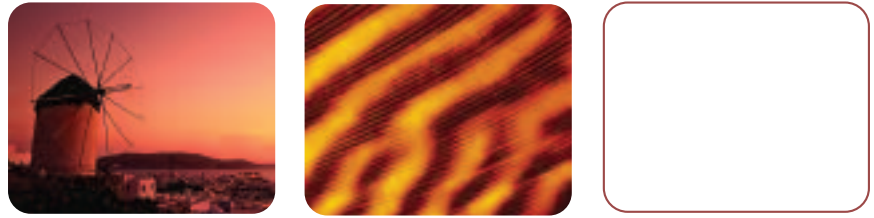
Agreement on harmonising direct taxes within the EU occurs infrequently so history was made in January 2003 when the EU finance ministers agreed to the Savings Directive whereby all EU Member States, with the exception of Austria, Luxembourg and Belgium, will automatically exchange information about cross border EU interest payments originating in their territories when the Directive comes into effect (probably 1 January 2005).

This will unquestionably have a major impact on the whole financial services industry throughout the EU and Switzerland, and, in particular, on the private banking

and investment management sectors, both onshore and offshore.

The position of Austria, Luxembourg and Belgium is that they will be allowed to levy a withholding tax on such interest payments in lieu of exchanging information. Also, importantly, the agreement reached does not necessarily commit Austria, Luxembourg and Belgium to move to an automatic exchange of information system after 2010, but makes this move dependent on the EU reaching unanimous agreement on satisfactory information exchange arrangements with the US, Switzerland and other territories.

The "dependent" offshore financial centres such as Bermuda, the Channel Islands, and Netherlands Antilles have also given commitments in various forms to cooperate with the EU on the Directive. However, at the time that these commitments were given it appeared that all EU countries and Switzerland would be required to agree to exchange of information, and it is now clear that Switzerland intends to retain its banking secrecy rules. While Switzerland may be prepared to agree to some exchange of information agreements along the lines of the OECD initiative explored below, this would appear not to extend to exchanging information in relation to an alleged failure to declare income, which does not constitute tax fraud under Swiss law.



The competitive position of the dependent territories has therefore changed since they gave commitments to cooperate in mid-2002. Some of their near competitors have been able to retain banking secrecy (at least for the moment) and will not have to operate a 35% rate of withholding tax until 2010. It remains to be seen whether the dependent offshore financial centres will wish to retain their competitive advantage by operating a reduced withholding tax of 15% and 20% in the interim period, but perhaps moving to exchange of information when the 35% rate becomes effective.

### The OECD initiatives on information exchange

It should not be forgotten that the OECD has been pursuing a parallel initiative to encourage both OECD members and so-called tax havens to agree to exchange information in relation to tax matters. The exchange of information agreement which the OECD is encouraging all countries to sign up to includes the following principles:

- “Transparency and effective exchange of information”
- No “secret tax rulings” or “negotiation” of tax rates
- Financial accounts in “accordance with Generally Accepted Accounting Principles” and “either audited or filed”
- Agreement to make available:

- “beneficial ownership information regarding all types of entity”
- “bank information relevant to criminal and civil matters”
- A legal mechanism that “allows information to be given to a tax authority of another country ... that will function effectively and can be monitored”.

The OECD’s initiative differs from the EU initiative in that it does not envisage automatic information exchange but rather the exchange of information on request. Most tax havens have agreed to cooperate with the OECD, though generally this is subject to conditions in relation to certain OECD members, such as Switzerland, also agreeing to cooperate.

As Switzerland is unlikely to exchange information in relation to alleged non-disclosure of income by non-Swiss

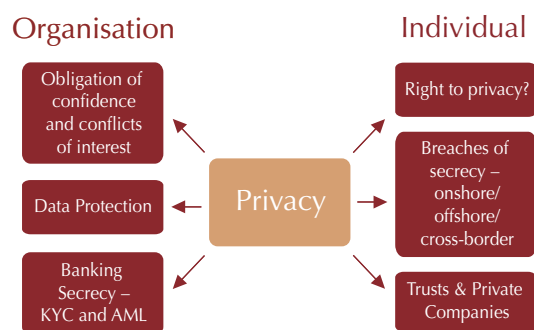
nationals, this may give tax havens, in particular, the opportunity to hold back from agreeing to exchange information in some cases.

The OECD has recognised the risk to its initiative as a result of the EU agreeing that three EU States should be exempted from exchange of information on tax matters.

One of the problems with the exchange of information is the natural conflict with an individual’s right to privacy (such that it is). As noted by Justice Louis Brandeis in *Olmstead v. US (1928)*: “The right to be let alone – the most comprehensive of rights, and the right most valued by a free people.”

In our opinion, there is no doubt that the world is moving to an era of greater information exchange between

Figure 4



Source: PricewaterhouseCoopers

## Wealth management – where to next? *continued...*

governments and generally greater transparency. For private banks and OFCs there is no doubt that this could undermine one of their traditional unique selling advantages. This also presents opportunities. For example, new structures that help mitigate the impact of the Savings Directive (relatively easy to achieve) or which quite legally mitigate or defer taxes will be eagerly taken up by clients. Referring to an earlier point in this article this is undoubtedly one area where the wealth manager can add value and make it more likely than ever that the client will see the relationship as a most trusted advisor relationship.

Individuals' rights to privacy and organisations' obligations to maintain adequate levels of confidence will be further eroded by new anti-money laundering and know your customer rules. This has been demonstrated recently, by law enforcers obtaining most of the information they required through targeting international gateways such as the internet and global finance houses without breaching existing data protection rules.

### **The future OFCs – a growth story**

While tax and information exchange developments are impacting the

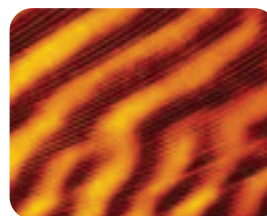
competitive positions of the traditional private banking centres, a number of new territories are establishing themselves as future OFCs. Focusing on the Middle East, Bahrain and the other Gulf Cooperation Council (GCC; whose members are Kuwait, Qatar, Oman, Saudi Arabia, Bahrain and the United Arab Emirates) members have witnessed a significant inflow of funds since September 11, 2001, according to a number of sources, including the Bahrain Monetary Agency ('BMA'). An indicator of this has been the performance of the stock exchanges in the region, which have shown strong growth during 2002, despite the fall in all of the major Western and Asian stock market indices.

Bahrain appears to have identified the opportunity and has been marketing itself as a gateway to the Middle Eastern private banking market. It has recently completed an in depth review of its strategy which, inter alia, is also designed to make it more attractive as a centre for private banking. Bahrain realises that to be a serious contender in the private banking market its laws and regulations will have to be seen to be "whiter than white" and is currently implementing a number of regulatory and legal reforms that will make it more attractive to private banks and acceptable to international regulators. For example, it was one of the first

countries in the region to introduce a law on anti-money laundering in early 2001. A new special type of license for private banks has also been drafted and a new trust law is being drawn up.

The numbers speak for themselves. A recent survey by the BMA showed that private banking assets in Bahrain had soared to US\$22 billion, 20% of the total assets held by Bahrain banks. The assets of high net-worth individuals from the Middle East and North African regions are estimated at between US\$1 and US\$1.3 trillion, of which 80 per cent is held by countries within the GCC. A McKinsey & Co analysis for the BMA suggests that revenues generated by these assets range from \$7 to \$13 billion. The wealth in the region is also concentrated in fewer hands. The average assets per high net worth individual (HNWI) are also estimated at \$5.9 million as compared with a global average of \$3.8 million. These assets are also expected to grow at rate around 25% faster than the global average growth rate over the next few years.

A growing portion of assets is moving into Islamic products. The Islamic funds invest in Sharia (Islamic law) compliant products/methods. The more popular products tend to include international equities, real estate, leases and trade finance. Bahrain is the Islamic banking centre for the



region and continues to be a very attractive location for Islamic banks/financial institutions and Islamic mutual funds.

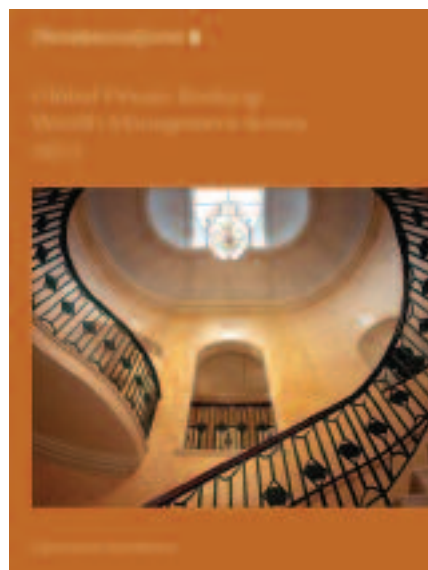
Another indicator of increasing popularity of Bahrain is the steady increase in the number of mutual funds marketed through Bahrain. These have increased from 1,121 at the end of 2000 to 1,377 at the end of 2002.

Another OFC that is increasing in popularity is Singapore, which is politically stable, has a steady currency and sound financial regulations. It also presents an opportunity for investors to tap into the Asian market, which according to the Merrill Lynch/Cap Gemini Ernst & Young Wealth Report 2003 will continue to grow at approximately 8% for the next few years. According to their report the region's high net worth individuals have an estimated wealth of US\$5.1 trillion making it the third largest market after North America and Europe.

## Existing OFCs

The outlook is not all doom and gloom however – Moody's, the international ratings agency, for example, recently reported that the traditional OFCs are growing despite the bear markets and pressures on banking secrecy. "Moody's expects the leading offshore private banks to continue to prosper," the report said.

Respondents to PricewaterhouseCoopers' 2003 Global Private Banking/Wealth Management survey<sup>1</sup>, launched in July, indicated an expectation that onshore centres will outperform the existing OFCs by a margin of around 5% on average. In addition considerable consolidation in the numbers of OFCs globally is expected to occur.



## Conclusion

One might still ask what management can do to address the pressures on the business models and the existing OFCs, notwithstanding the growth predictions made by some organisations? Not much unfortunately, in so far as changing the course of governments; however,

organisations can decide which OFCs they want to be operating in and which ones not. The playing field has been fundamentally changed by September 11 and tax harmonisation and the consequences are that private banks need to understand more effectively where their clients are being sourced from and whether they have access to products that would best meet their current and future needs given the changes in taxation.

Many organisations are re-evaluating their business models and, as part of this, private banks have started to consolidate their operations in one or possibly two centres reducing their exposure to the offshore as well as rationalising cost savings as they do so. The more difficult question for organisations and OFC, alike, is which OFCs will survive and prosper in the next 10 years and which ones will not.

Private banks are trying to deal with cost pressures and falling revenues through outsourcing and open product architecture and now they will also have to deal with the changing shape of the offshore centres and flow of money.

This alone will not be enough: private banks will have to focus on what will differentiate them from the rest. They will have to decide which markets they want to serve – where, how and with which products.

<sup>1</sup> [www.pwc.com/globalwealthsurvey](http://www.pwc.com/globalwealthsurvey)

# Changing the European credit card landscape – a challenge too far?

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by Patrick Atkinson, Jens Roennberg and Jose Wahnón



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The credit card market globally has never been as competitive, nor have the techniques used by the major credit card companies been as innovative, as they are today. Yet the market in Europe and hence in some of the world's largest economies remains remarkably underdeveloped given the size of the credit card markets in the US, Asia and the UK.

The credit card market globally consists of some 1.5 billion cards which carry out around US\$3.5 trillion transactions annually.

By far the biggest market is the US, where 743 million general purpose cards<sup>1</sup> carry out some US\$1.3 trillion transactions every year.

Replicating that level of credit card use in Europe is the dream of many credit card company executives. Western Europe represents the last major wealthy fortress holding out against the use of credit cards, a relatively untapped market with some 250 million people with an average country per capita GDP of US\$20,000 to \$40,000<sup>2</sup>.

This can be attributed to three main factors: the stage of maturity of each

market, consumer behaviour and structural considerations (such as settlements and clearing systems, legal restrictions and language).

### The challenges of the European Market

Market maturity is clearly a key factor in determining the challenges faced by incumbent market participants and possible new entrants.

In mature markets, management's focus is on optimisation of a company's position in the value chain and management of key elements of it, namely the ownership and management of customer information, customer analytical capability and operational skills and behaviours.

The US and UK markets fall into this category. The US market began its development during the 1920s, when individual organisations, such as hotel chains and oil companies, began issuing cards to customers for purchases made at those businesses. In the 1950s, 60s and 70s, universal charge and credit cards evolved, as well as magnetic strips and electronic authorisation and processing.

With the integration of technology within the card industry and increasing data availability, information management and analysis have become core competencies of the US card industry. Companies use account and transaction data for customer marketing and retention programmes, product innovation, development and differentiation, as well as for managing credit and operational risk.

In the UK, the market was born with the launch of Barclaycard Visa in the 1960s, followed by Access, a Mastercard product. In the past decade, the aggressive pricing strategies pursued by US monolines<sup>3</sup>, such as MBNA and Capital One, and new entrants, such as Egg, have made the UK market fiercely competitive. US expertise in customer relationship analytical capability is making it possible to transform the market from one of single price points to personal pricing. Further developments in the UK market are considered later.

In developing markets, gaining/retaining market share, the identification of and migration to more profitable customer segments, and the identification of

<sup>1</sup> Cards branded Mastercard, Visa, Optima and Discover

<sup>2</sup> For comparison: EU and Euroland: €18-44,000

<sup>3</sup> Monolines: credit card only companies

# Changing the European credit card landscape – a challenge too far? *continued...*

operational efficiencies are key drivers. Developing markets for credit cards in Europe include France, Germany, Spain, Italy, The Netherlands and Belgium. Cultural and structural barriers are holding back developments in many of these markets, as evidenced by the difficulties UK card issuers have in gaining market share in France and Germany.

In markets at an earlier stage of development, there are significant barriers to entry, not only in terms of gaining market share from incumbents but also in terms of promoting the existence of

a credit card market at all. In Europe, only a handful of players have had substantial success in gaining a significant market share of cashless payments outside their home market, and the credit card market has really yet to develop at all in some countries. Most Eastern European markets fall into this category.

## Consumer behaviour and structural considerations

Developing a credit culture and promoting revolving credit is key to replicating the US and UK models in Europe, and to

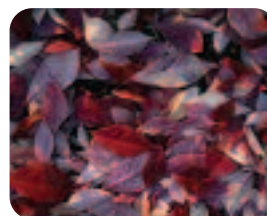
achieve this, new entrants need to gain an understanding of local markets. In addition, it is critical for new entrants lacking historical credit data for scoring and limit setting and knowledge of local conditions and consumer behaviour to avoid incurring significant credit losses.

Elsewhere, experience has shown that it may be a long, bumpy road to profitability. Entrants into certain Asian markets, such as Korea and Hong Kong have found that rapid growth can be achieved but with it come increased risk of significant credit losses. The annualised credit card charge off rate in Hong Kong was 13.45% in the final quarter of 2002. In Korea, analysts expect it to exceed 10% for the first half of 2003. This compares with a typical rate of 3-4% in the UK. Acceptable levels of profitability may be more potential than real in the short to medium term.

The US market shows considerably higher numbers of cards per person, credit transactions per person and credit transactions as a proportion of total transactions than is the case for Europe. Losses recently experienced by some US providers have also been substantial.

Germany	
Number of cards	107,812,000
Number of transactions	3,837 million
Value of transactions	Euros 453,595 million
Attitude to extended credit terms	Conservative, credit transfers using the giro system and overdrafts are prevalent.
Pay later cards as proportion of total cards	Low. Based on 2001 data, despite higher than average card usage overall, low use of credit/charge cards (second only to Denmark in Western Europe).
Relative importance of payment schemes	Eurocard/Mastercard dominates, with Euros 436 billion of total Euros 454 billion of transactions. Visa making headway via pay later market.
Key players	Savings and "Volks" banks account for 78 million of 108 million cards in issue.  Largest non-domestic pay later players in terms of market share of cards are Barclaycard (6%), Citibank (5%) and Santander (3%).

*Source: Datamonitor*



France	
Number of cards	42,751,000
Number of transactions	4,432 million
Value of transactions	Euros 233,131 million
Attitude to extended credit terms	Acceptance of cards as a form of flexible short-term personal financing.
Pay later cards as proportion of total cards	High. One of a group of countries with the lowest overall level of card ownership, but behind only the UK and Spain in terms of pay later cards per person (0.5).
Relative importance of payment schemes	Visa is market leader (48% of cards in issue, 53% of transactions by value). Eurocard/ Mastercard a close second (41% of cards in issue, 39% of transactions by value). Domestic cards have 10% and 7% respectively.
Key players	Credit Agricole (31%), Credit Mutuel (14%) and Credit Lyonnais (11%) make up more than 50% of French pay later card numbers. No significant foreign players, although some attempts are now being made, e.g. Egg.

*Source: Datamonitor*

The US market's single corporate legal system, homogenous banking, settlements and clearing systems and positive attitudes to credit across the country make the US market:

- Easier to treat as a single market and hence take advantage of economies of scale
- A market where higher revenue generation is possible through offering extended credit terms

In many parts of Europe, however, numerous legal systems and languages are coupled with more negative attitudes to consumer credit.

This difference in attitudes is partly as a result of familiarity with the systems of non-cash payment currently in place, principally debit cards and credit transfers. "Pay later" issuers in Europe face stiff competition from "pay now" schemes such as Maestro, which offers international payment functions and is cheaper for customers. In Western Europe the strongest "pay later" cultures in terms of credit/charge cards per inhabitant are in the UK, Spain, France and Norway (see Figure 1 for value of transactions per customer) with the lowest levels in Germany, where credit-transfers are prominent, and Denmark. It is also partly as a result of the existence in some

cultures of more conservative European attitudes to extended unsecured credit than those shown by consumers in Anglo-Saxon markets.

This conservatism was recently explained by Lars Nyberg, Deputy Governor of the Sveriges Riksbank (the Swedish Central Bank) at the Scandinavian Card Markets conference in February 2003, "in Sweden, consuming out of credit is still considered to be somewhat irresponsible".

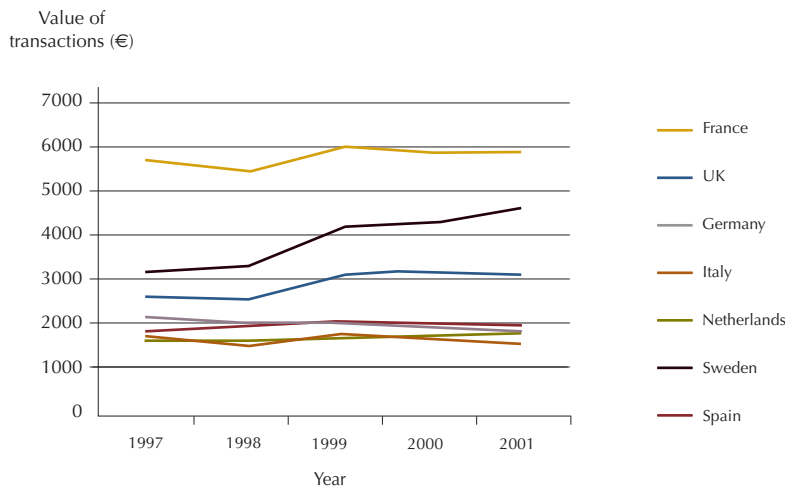
In Spain, the use of credit, as opposed to debit cards, is not due principally to the need for credit or the flexibility of revolving credit, but due to the opportunity to gain other benefits (via loyalty schemes) or as a means of paying business expenses (i.e. principally travel and entertaining). Debit cards, however, are broadly used due to the convenience attached to them and cheque use is almost nil.

So, the challenge, for new entrants to the European market, is not so much to demonstrate that their product is better than that of their competitors, as to generate interest in a new kind of product altogether.

While it may seem incredible given the widespread use of credit cards in the UK today, the same reluctance to use revolving credit was encountered by Barclaycard when it launched the first credit card in the UK in the 1960s.

# Changing the European credit card landscape – a challenge too far? *continued...*

**Figure 1: Value of transactions per annum per customer with a pay later card**



Source: Datamonitor

## How will the credit card market in Europe develop?

In one key respect the UK market is similar to those of other European countries. Domestic banks dominate Europe's credit card markets. In the UK, new entrants, mainly from the US, have aggressively targeted both existing users and segments previously underserved by the established players (such as the higher risk sub-prime market), following growth strategies based on a combination of organic growth, acquisition and white-labelling<sup>4</sup>.

Growth has been driven by a combination of efforts to win existing cardholders and to grow the number of cards in circulation, based on US experience of consumers holding a far higher number of cards than is the case in the UK (see Figure 2).

The UK competitive playing field has been marked by a number of initiatives in the last five years:

- Aggressive pricing by new entrants/US issuers
- Low APR<sup>5</sup> and 0% balance transfer and introductory period offers, leading to the phenomenon of switchers (customers prepared to seek out the best priced card), with a proportion of the market moving from provider to provider on a regular basis

While credit card markets might evolve in Continental Europe in the same way as in the US and UK, it is possible, given the differing consumer attitudes to managing personal finances, and to revolving credit in particular, that a model of mature credit card market may develop in Europe different from that which has already developed in the US and the UK.

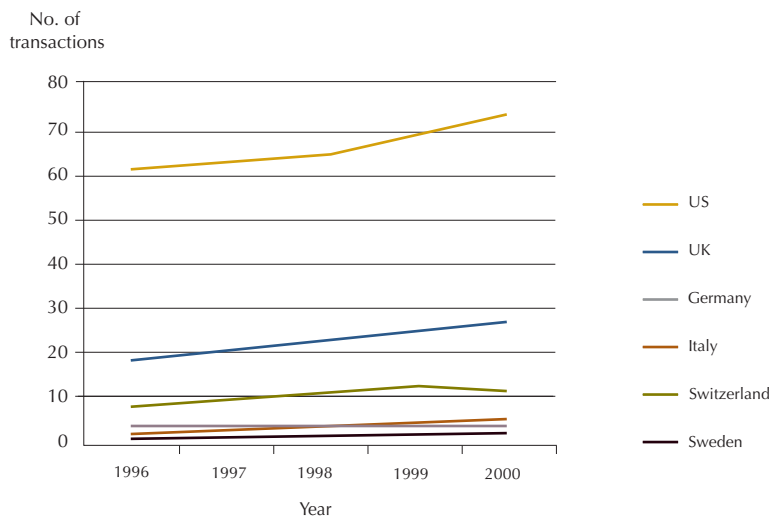
In addition, regulatory developments will have a significant impact. Pan-European regulation such as interchange reviews by the EU Competition Commission, and the Consumer Credit Directive, will be coupled with local regulation and local interpretation of regulation. In Germany,

for example, the Financial Action Task Force on Money Laundering's Recommendation 9 (which recommends that appropriate national authorities should consider applying 13 of the recommendations to the financial activities of businesses which are not financial institutions) already has been introduced into German banking law covering qualifying credit card businesses. The specific implications of this to providers in Germany are covered in PricewaterhouseCoopers' publication on credit card company regulation entitled "Vorschriften für Kreditkartenunternehmen."

<sup>4</sup> White-labelling – providing credit card services (including processing, taking credit risk, providing funding), for companies/banks who provide their brand  
<sup>5</sup> APR – Annual Percentage Rate



**Figure 2: Number of credit card transactions per inhabitant**



Source: Bank for International Settlements

**Precious Plastic 2002**



Precious Plastic 2002 provides a market analysis of the UK credit card industry and valuable insight into the issues facing it, covering a range of topics from customer segmentation and consumer dynamics to the impact of fraud on the industry.

For further information please visit [www.pwc.com/uk/preciousplastic](http://www.pwc.com/uk/preciousplastic)

- Cashback offers (as offered for example by Egg, Morgan Stanley and American Express)
- Offering cards to individuals to whom cards were previously not available due to a poor credit history, short tenure in current employment, and so on

For the mature market model to be replicated in Europe, new entrants have a number of options (see Figure 3):

So will this experience in the UK be replicable in Continental Europe, where the challenge is also both to win customers from incumbents and to grow the overall size of the market?

**Figure 3**

Approach	Requires
Price competition	Innovative operational design
Increase take up of extended credit	Customer analytical capability to avoid credit losses
Increase/stimulate transaction volumes	Increased number of points of sale and incentives for card use
Open up alternative distribution channels	Customer information to allow direct mailings etc.

Many of today's European markets are characterised by a reluctance to take on revolving credit, reducing the amount of interest income available, and comparatively low transaction volumes, leading to lower income from interchange<sup>6</sup>.

This, together with a lack of aggressive domestic price competition, has led to high annual card fees, interest rates and interchange fees, thereby compensating for low transaction and credit volumes.

<sup>6</sup> The fee taken from the retailer at the point of sale and split between the card acquirer (who provides the terminal) and the card issuer

# Changing the European credit card landscape – a challenge too far? *continued...*

Spain	
Number of cards	48,758,000
Number of transactions	1,675 million
Value of transactions	Euros 107,315 million
Attitude to extended credit terms	Second highest numbers of pay later cards in Europe after the UK. The challenge for issuers is to convert deferred debit into extended credit.
Pay later cards as proportion of total cards	Above average. Spain has average levels of pay now cards for Western Europe but is second only to the UK in terms of pay later cards with 0.6 cards per person.
Relative importance of payment schemes	Visa is the clear market leader (with 57% of cards in issue and 59% of transactions by value) with Eurocard/Mastercard having grown from around half the size of Visa in 1997 to 42% of cards in issue and 40% of transactions by value). American Express and Diners Club are niche players.
Key players	Highly fragmented market. The only issuers with greater than 5% market share are La Caixa (a Catalan Savings Bank), with 11.7%, BBVA (11.5%) and Santander Central Hispano (5.3%). The largest non-domestic participant is Citibank, with 2.5% of cards in issue.
<small>Source: Datamonitor</small>	

**Price competition** will require cost control to mitigate lower income levels. In the UK, outsourcing has been used effectively as a means of cost control and actively managing separate links in the value chain. There are, however, practical barriers to achieving economies of scale on a pan-European basis. Lack of available language skills, for instance, can be a barrier to achieving pan-European economies of scale. A small number of players with global ambitions

have entered a number of European markets and yet service them from single centres. Flexibility is required in the operating model used in terms of where to locate sales and marketing activities, customer contact centres and back office processing activity to optimise cost considerations and still provide an acceptable level of client service, as well as meeting local regulatory and labour market requirements.

The ultimate aim, though, is convincing European consumers to enter into **extended credit terms**, by not paying off the whole of their balance at the end of their interest free period. For this strategy to be profitable, it is important not only to change attitudes within Europe, but also to possess a sufficiently developed customer analytical capability to avoid painful first-mover credit losses.

While incumbents hold a substantial amount of customer data as a result of their ongoing banking relationships, advanced customer analytical techniques as used by US and certain UK issuers are not yet in widespread use in Europe. On the other side of the equation, issuers who do possess such a capability lack the customer data with which to use it.

**Increasing transaction volumes** is difficult for credit card issuers entering a new market, as the ability of customers to use cards is controlled by merchant acquirers. Despite this however, some reward schemes have proved an effective means of stimulating spending. The Nectar scheme launched successfully in the UK in 2002 linked a card issuer with chains of supermarkets, department stores and petrol stations, and added another dimension to the already extensive range of loyalty schemes available in the market (Air Miles, individual issuer schemes, etc.). In Spain,

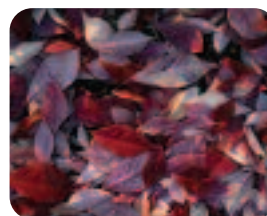
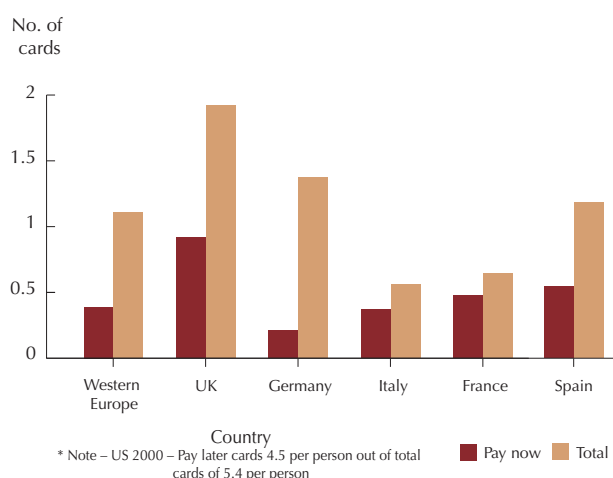


Figure 4 Number of cards with a credit/charge function per inhabitant (2001)\*



Source: Datamonitor and Bank for International Settlements

affinity and loyalty cards are becoming popular and, as in the UK, large football teams, such as Barcelona, have started to launch their own cards. There is a range of further options for alliances between card issuers and retailers.

A range of **alternative distribution channels** exists for card providers to attract new customers. These include direct mail, mailshots in magazines, face-to-face marketing in shopping malls, airports, railway stations, etc. Again, the effective management of the credit risk which is taken on as a result of lending to these customers relies heavily on obtaining accurate customer information, either through detailed applications and verification procedures, or through possessing customer information via acquisition or alliances with other card providers, financial institutions or the financial services arms of retailers.

The store card market too is more developed in the UK than in most of Europe. Major retailers such as Aldi and Lidl in Germany, El Corte Ingles in Spain and those linked to the Points Ciel programme in France are potentially rich sources of customer information and could provide access to large customer bases. It may be a matter of when rather than if these retailers launch their own credit products or enter into alliances with card issuers. In Germany, the retailer Karstadt

## Hungary

Number of cards (June 2001)	4,600,000
Number of cards per capita	0.4
Pay later cards as proportion of total cards	Low. Credit cards made up around 362,000 of overall cards in issue at end June 2001. High growth rates in credit cards from almost non-existent market at end 1998 (end 1999, number of cards 148,000; end 1998 3,000).
Key players	Highly concentrated market. The four largest players account for 87% of the market, with OTP Bank alone accounting for 62%. The largest non-domestic participants are K&H (part of ABN AMRO) and Citibank. Citibank is the market leader in pay later cards.

Source: Hungarian National Bank, K&H Research

# Changing the European credit card landscape – a challenge too far? *continued...*

Czech Republic	
Number of cards (December 2000)	4,000,000 – 4,500,000
Number of cards per capita	0.4
Pay later cards as proportion of total cards	Low. Around 500,000 credit cards in issue (11-12% of overall cards)
Key players	Highly concentrated market. The four largest players account for 87% of the market, with OTP Bank alone accounting for 62%. The largest non-domestic participants are K&H (part of Highly concentrated market. More than 80% of cards issued by one of three players (Često Spořitelna, Komerční Banka, and ČSOB) Citibank has started to issue cards and other possible foreign players include ING.
<i>Source: The Czech Bank Cards Association (bankovníkarty)</i>	

has entered into a Joint Venture with ERGO Insurance to issue Mastercards via Karstadt Quelle Bank. GE is an example of a major store card provider that is expanding into Europe.

### Is the current UK operating model sustainable?

We consider briefly here the likely direction of the current operating model for cards in the UK. As discussed above, low APRs, 0% balance transfer and introductory 0% on purchases offers have become the norm in the UK market. Consolidation is underway as a result of the decision by some smaller players that economies of scale and increasing sophistication in both customer targeting and operational management

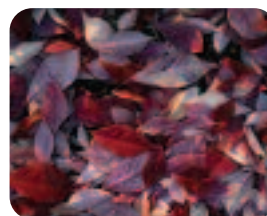
represent serious barriers to building a significant market share. The acquisition by MBNA of Alliance and Leicester's and Abbey National's card portfolios is an example of this.

As consolidation continues, competitive pressures are likely to ease and such initial pricing offers may no longer be necessary, or may take on a different form. As discussed in the PricewaterhouseCoopers publication 'Precious Plastic', pressure from the Office of Fair Trading in the UK, and from the European Commission, has led to the expectation of a significant reduction in interchange fees for Visa and Mastercard and hence for Visa and Mastercard issuers. In effect interchange fees have funded the loyalty schemes

offered by card issuers, be they cashback or points based. These reductions would make unprofitable the large proportion of customers who pay their balance in full every month and make full use of loyalty schemes.

We are already seeing card issuers react to the expected reduction in interchange fees by reducing cashback amounts (such as HBOS or Morgan Stanley) or changing points redemption values (such as Goldfish).

While options are still available for card issuers to improve their profitability through the management of credit and fraud losses (PIN at point of sale technology was introduced in France 10 years ago and has significantly reduced card fraud), cost reduction initiatives such as outsourcing as well as enhanced customer retention through loyalty schemes, it is doubtful that the existing combination of reduced interchange income and 0% offers represents a sustainable long-term model for the recent new entrants to the UK card market.



## Conclusions

In the UK market, reductions in interchange income together with fierce price competition mean that management will seek to:

- Enhance profitability by replacing interchange income with alternative sources such as fee based income through cross-selling.
- Maximise value for smaller and medium sized players through alliances/outsourcing arrangements, or acquisitions between incumbents and white labellers/affinity card players. This will bring together customer analytical capability and critical mass in back office processing functions between incumbents with customer information and distribution channels and white labellers/affinity card players with customer analytical capability and critical mass in back office processing functions.

In common with most markets for financial services, the European credit card market is highly fragmented and made up of many individual country markets.

The ability to sell the concept of revolving credit to consumers is a prerequisite for the development of a profitable US/UK-style credit card industry in Continental Europe.

Significant barriers to entry exist for players looking to move into Continental European markets but the potential size of the market and the potential for exploiting economies of scale mean such a move remains attractive to players with global ambitions.

With the uncertainty over the direction of market development in some European countries, the US model may not be the only definition of “mature”. Given the varied histories of development of different portions of the global market, it is possible that there will be a number of different mature models.

While we expect domestic banking consolidation in European markets followed by cross-border mergers will shape the future of the European market innovations by monolines/global credit card players may make inroads into domestic European credit card markets before this.

Future regulatory developments such as interchange reviews by the EU Competition Commission and the Consumer Credit Directive will impact the shape of the European card industry in the future.

## So what next?

Senior management who plan to expand their credit card businesses in Europe will need to:

- Determine whether their card business strategy will operate separately from or in conjunction with an overall business strategy (i.e. including banking business, travel business, etc.)
- Develop a clearly defined strategy as to which markets to target and which key customer segments are to be targeted in these markets.
- Determine the optimal method of entry, via organic growth, via acquisition of a business or a portfolio or via an alliance. Consideration should be given to alliances with domestic banks or existing store card providers.
- Gain a detailed understanding of target market payment systems, regulatory considerations and consumer behaviour.
- Ascertain which elements of the operating model will need to be carried out locally due to structural considerations such as regulation or language, and which can take advantage of pan-European economies of scale.
- Be ready to react opportunistically.

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## New – and non-traditional – survival strategies for financial services firms



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## Customer Relationship Management: transforming the retail banking industry

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## Market transparency – the need for better external reporting of risks and controls

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## Wealth management – a new world order?

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