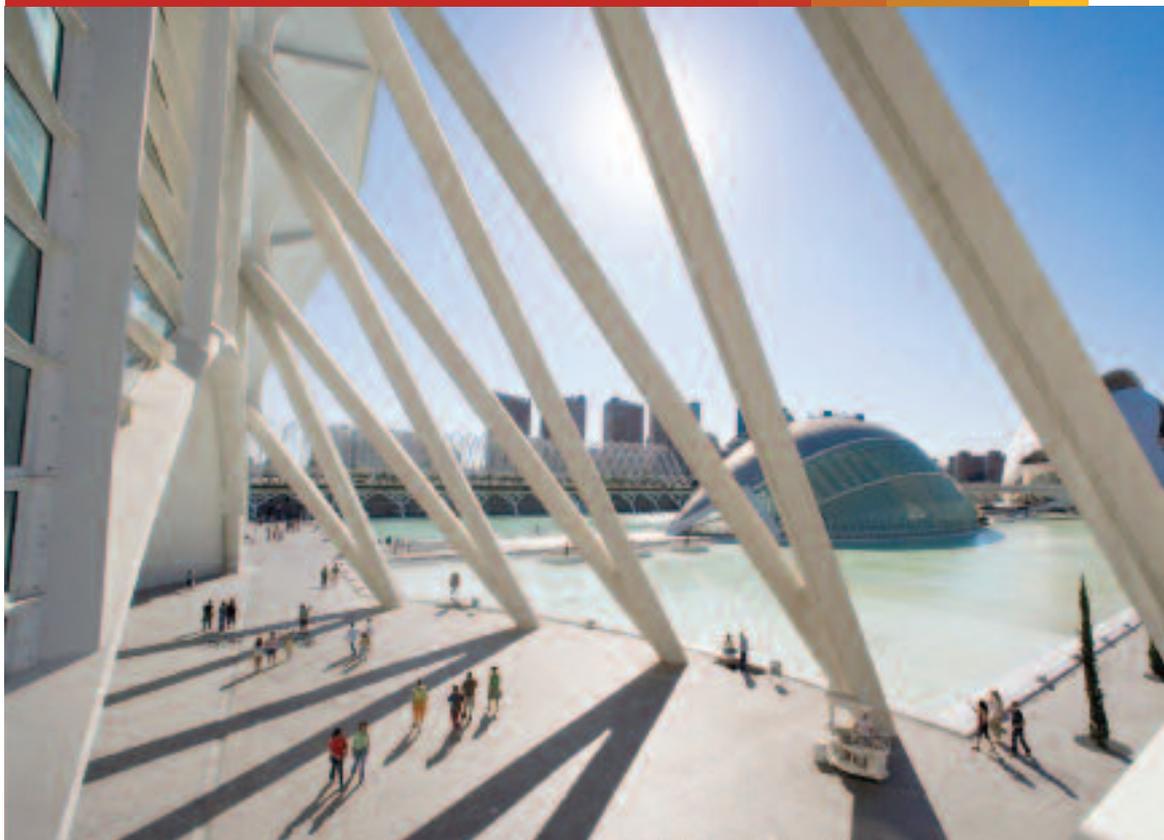


Project Blue: From ubiquity to precision

*The world of banking
could change beyond all
recognition over the next
ten years. Are you ready?*

January 2011



Contents

<i>Introduction</i>	3
Reaching a watershed	
<i>Exploring the mega trends</i>	4
<i>Global banking survey</i>	6
Bankers' perspectives on the challenges ahead	
<i>Dealing with the impact</i>	9
<i>Making sense of an uncertain future</i>	10

Introduction

Reaching a watershed

The environment in which bankers have spent most, if not all, of their careers has changed. Having outstripped expansion in GDP for nearly 30 years, growth in the banking sectors of the Western world has stalled.

Looking ahead, Western banks may struggle to sustain even modest growth. Where the emerging markets of South America, Africa, Asia and the Middle East (SAAAME) once presented huge opportunities for Western banks, these banks are now facing stronger, more capable and more confident competition from SAAAME rivals, both within the emerging markets and, increasingly, on their own turf. Underlying challenges to the Western banks include the tightening grip of government control, mounting pressure on natural resources and declines in working age populations.

If you're a Western bank, will your business model still be viable in this rapidly changing economic and industry landscape and how can you put your business on a more competitive footing? If you're an emerging market bank, how are you going to capitalise on the opportunities ahead?

Project Blue is designed to help you plot a successful course through this unfamiliar and still largely uncertain future by setting out a series of potential scenarios and resulting policy considerations. Our analysis is built around four 'mega trends' that are reshaping the world of banking:

- Rise of the emerging markets
- Rise of state directed capitalism
- Demographic shift
- War for natural resources

'Neither a wise man nor a brave man lies down on the tracks of history to wait for the train of the future to run over him.'

Dwight D. Eisenhower

We've identified five scenarios for each trend, ranging from 'business as usual' (banking continues on its existing course) to 'new world order' (banks face severe threats on multiple fronts). Our analysis is supported by a global survey of more than 500 senior executives in banking, who were asked to judge the most likely scenarios and assess the implications for their industry.

Project Blue examines the drivers of change over the short-, medium- and longer terms. This report concentrates on the longer term as this is when the full force of these changes will be felt. However, many of the trends are already manifesting themselves in areas ranging from mounting pressure on natural resources to the ever tightening grip of government control. Smart banks have

begun to prepare for the new reality. Recognising the implications of the developments ahead and responding with the necessary strategic precision will provide a once in a generation opportunity to put clear blue water between you and your competitors. Failure to assess and address the impact could put your institution at ever more pressing risk of competitive marginalisation.

Exploring the mega trends

Four accelerating mega trends are already reshaping the world of banking. The longer term impact could be even more dramatic.

The banking sector has regained a measure of stability. Yet it may be wishful thinking to anticipate any return to the consistently high levels of growth of the pre-crisis era. History has reached a watershed in which long held assumptions about power, prosperity and the banking industry's place at the apex of this world order may no longer be valid.

Rise of the emerging markets

'London and New York will have to share their dominant roles with some new financial centres.'

PwC global banking survey participant

Our latest analysis anticipates that the GDP of the largest E7 emerging economies will overtake the current G7 economies by 2020, and China may already have surpassed the US by the end of the decade.¹ If you're an E7 bank, the combination of rapid economic growth and increasingly affluent population within your home market creates huge commercial potential. Faced with stagnating growth at home, many G7 banks are looking to strengthen their presence in the SAAAME markets. Yet regulation and local competition could make it more difficult for G7 banks to penetrate these markets. Western banks could also find themselves on the defensive in their home markets as E7 banks look to expand overseas. In turn, a growing amount of emerging-to-emerging market business is bypassing the West altogether, which is leaving G7

banks increasingly out of the loop. A sign of the growing financial integration within the SAAAME trading bloc is Industrial and Commercial Bank of China's (ICBC) acquisition of a 20% holding in South Africa's Standard Bank, which has given ICBC access to Standard's extensive network across the resource-rich continent.²

Rise of state directed capitalism

'Governments will try to move away from the free market economy to a more regulated one as social pressure mounts, people become more risk averse and rely more on the state to take care of them.'

PwC global banking survey participant

Having supported banks through the crisis, governments and voters will expect them to demonstrate that they're socially and economically useful. The impact can already be seen in more stringent regulation of capital and liquidity and the threat to break up groups deemed too big to fail or add even more capital requirements. In future, many Western banks may find it more difficult to invest overseas as they're forced to focus on supporting local business. In the wider economy, we've also seen an apparent increase in the number of foreign takeovers being rejected by governments on the grounds of national interest. Prominent examples include the failure of BHP Billiton to get the go ahead for the purchase of Canada's Potash Corp, the

world largest fertiliser maker.³ Other examples include the rejection of Chinese phone maker, Huawei Technologies', bid for US computer equipment manufacturer, 3Com Corp.⁴

War for natural resources

'Global instability will increase and the standard of living in the US and other first world nations is likely to suffer in the coming years.'

PwC global banking survey participant

Supply may not be able to keep pace with rising global demand for natural resources, putting pressure on industrial output, forcing up prices and creating the potential for social unrest and global conflict. It's notable that threats to food and water security and the resulting potential for geopolitical instability feature prominently in the World Economic Forum's Global Risks 2011 Report.⁵ Banks will need to think about how to adjust to a world where certain assets become increasingly scarce and valuable. They are also set to face growing pressure to invest in companies that promote sustainable technologies and may need to work out new risk parameters as a result.

Demographic shift

There will be significant opportunities to provide wealth solutions for ageing populations. However, declines in working age populations in both Western and Far Eastern economies could lead to slower growth, depress asset prices and create the potential for severe social tension. The impact of this trend is already evident in rising savings rates and growing uncertainty over the adequacy of retirement income. Banks face a significant impact on their growth prospects, sources of investment and how they manage their assets and interact with their customers.

'India has 500 million people under the age of 30, creating a huge pool of earners and consumers, which will feed industry and growth and attract more big international companies to set up hubs.'

PwC global banking survey participant

1 The World in 2050: The accelerating shift of global economic power: challenges and opportunities, published by PwC in January 2011.

2 Reuters, 25.10.07

3 Reuters, 15.11.10.

4 Bloomberg, 03.08.10.

5 Global Risks 2011, published by the World Economic Forum in January 2011.

Global banking survey

Bankers' perspectives on the challenges ahead

Survey participants have disparate views on the most plausible scenarios for their industry, with Western bankers more likely to anticipate a return to the status quo than most of their emerging market counterparts.

Figure 1: The most likely scenario

Respondents were asked to identify which of 5 scenarios was most likely. The grid below highlights the most likely scenarios chosen by the total number of survey respondents.

	'Business as usual' Banking continues on its existing course	
	Scenario 1	Scenario 2
Rise of the emerging markets	<ul style="list-style-type: none"> The West remains the dominant decision making and economic power in global banking London and New York remain by far the largest global financial centres Western regulators and central banks alongside the IMF continue to be recognised as the thought leaders in global financial services <p>11%</p>	<ul style="list-style-type: none"> The West remains the central decision making and economic power in global banking Emerging markets grow in scale and importance; however Western banks are able to exploit these markets, entering aggressively and capturing significant market share Eastern financial centres rise up the global rankings to sit just behind London and New York Western regulators and central banks begin to take account of the decisions made by their emerging market counterparts <p>29%</p>
Demographic shift	<ul style="list-style-type: none"> Healthier and longer-living populations mean Western GDP continues to grow Western banks thrive as they develop new products to support demand for financial services at stages of the ageing population's lives Growing and more affluent populations in emerging markets offer new opportunities for Western banks to offer financial services and / or assist in managing their assets <p>13%</p>	<ul style="list-style-type: none"> Maintaining acceptable retirement prospects for future pensioners in Western societies requires young people in faster growing economies (e.g. India) to buy up Western assets New business models emerge to allow this transfer, dominated by Western banks as they have access to The Western customer base and deep experience in wealth management Emerging market banks capture most domestic customers from their growing middle and upper classes In Western countries with a shrinking population, immigration is increasingly relied upon to drive continued economic growth <p>36%</p>
War for resources	<ul style="list-style-type: none"> There will be limited, if any, dispute (economic, political or military) over resources Global supply will meet demand even as the global middle class increases dramatically Banks will make a smooth transition towards financing the businesses of the future which will be focused on doing more with less <p>9%</p>	<ul style="list-style-type: none"> Natural resource pressures will remain, but consumer demand and technological improvements will balance and / or rectify challenges (e.g. super-clean energy will become economically viable) Banks will need to facilitate some write-off of stranded assets, but will generally shift their portfolio mix to reflect global demand to finance new technologies and infrastructure Global trade and financial co-operation will remain intact <p>31%</p>
Rise of state directed capitalism	<ul style="list-style-type: none"> The previous trend towards a laissez-faire operating environment for banks and businesses returns to The West Emerging markets begin to slowly re-liberalise their financial markets Banks have to comply with additional regulation, but do not face greater requirements to demonstrate their social utility Recently imposed capital controls are removed or relaxed <p>8%</p>	<ul style="list-style-type: none"> Regulators conclude that despite the financial crisis, the basic model of universal banks and the overall financial system serves society well Banks need to operate with some stricter capital, liquidity, transparency, and regulatory controls (e.g. derivatives) but these are manageable Countries improve their macro-prudential management to help prevent bubbles and hot-money flows, but these are both beneficial to the financial system and the wider economy <p>29%</p>

About the survey

In December 2010 and January 2011, PwC carried out a global online survey of 560 senior banking executives. Participants were asked whether the different scenarios outlined in Project Blue are plausible and which one they believe is most likely.* Our thanks are due to all those who participated, for sharing their insights with us.

* Please note that totals do not always add up to 100 because of rounding to the nearest whole number.

'New world order'

Western banks are attacked on multiple fronts

Scenario 3

- The West remains an important decision making and economic power in global banking
- Emerging markets grow in scale and importance; however limit the growth opportunities for Western banks seeking to enter or expand in these markets
- South America, Africa, Asia and the Middle East begin to demonstrate interconnectivity across trade and financial flows

35%

Scenario 4

- The West diminishes as a decision making and economic power in global banking
- Emerging markets grow in scale and importance but limit the growth opportunities for Western banks seeking to enter or expand in these markets
- Emerging market banks can freely enter The West and do so sporadically
- South America, Africa, Asia and the Middle East are widely recognised as a region of interconnected trade and financial flows

16%

Scenario 5

- South America, Africa, Asia and the Middle East become a largely self sufficient and dominant economic, financial and trading bloc; confirming a shift in global economic power
- Western banks are locked out of the major emerging growth markets and struggle to remain relevant in the new world order
- Emerging market banks can freely enter The West and do so aggressively (both organically and by acquisition)

9%

- Social tension arises in Western markets due to the increased costs of supporting an ageing population (for example healthcare and pensions)
- Asset values (particularly real estate) are flat or declining in The West, exacerbating a decline in the quality of retirement for pensioners
- Western banks stagnate as older populations need less financial services and banks are blamed for poor investment returns

34%

- Major intergenerational conflict emerges in aging societies, denting already slowing economic growth
- Younger people in The West do not trust banks and use non-bank alternatives, further decreasing the market for banking
- Cross-border investment faces increasing regulatory issues, essentially preventing young people in emerging economies from buying assets from retirees in developed countries, this further depressing asset prices
- Many Western banks need to shrink to survive

12%

- The Western economy and financial system cannot cope with reducing GDP and shrinking and / or ageing populations, leading to significant social problems and unrest
- China's social stability is threatened as its own economic growth is halted by its aging population
- Banks go bankrupt or are nationalised as bad debts overwhelm them

6%

- Climate change creates instability in food production, but also spurs more investment in low carbon technologies
- Increasing pressure on water, particularly rivers that flow internationally, heighten regional tensions in some places
- Banks take major write-offs on stranded assets, but adapt to the new realities as the requirement for investments to be sustainable will become the key driver of the way banks allocate capital

40%

- Peak oil production is reached with no apparent possibility of replacement with alternative fuels. This drives oil prices up to a level where global trade effectively reverses
- The reversal of global trade drives a world-wide drop in the standard of living and causes the growth of a global middle class to falter
- Major reduction in snowfall in the Himalayas, causes increasing water stress in India, China, and other parts of Asia. Similar water stresses are experienced elsewhere
- Global co-operation starts to break down as countries hoard their own resources as a security measure

17%

- Major military powers take direct control of oil reserves and other strategically important natural resources
- Regional water conflict become major armed conflicts in several places
- Food production plummets in many regions, both because of climate change, and because of lack of access to oil-based fertilizer

3%

- Governments continue to believe in capitalism and a strong financial system; however, they exert increasing control over both banks and the real economy
- Regulatory changes are numerous and the overall effects are not well understood, therefore negative unintended consequences begin to emerge
- Society demands banks demonstrate that they are socially useful and bankers are essentially viewed as quasi-public figures who have a duty to the entire society
- Governments actively promote national champions, both in banking and other commercial sectors

42%

- Cross-border investment becomes increasingly difficult as countries support and defend national champions and security interests
- Banks are increasingly directed to lend to certain industries and companies
- Banks products and prices are increasingly defined by governments, with some products deemed as utilities to be provided for little or no cost
- Currency exchange rates are used aggressively as competitive tools
- Countries co-operate on a regional basis to some extent, but global co-operation becomes more and more difficult

14%

- Governments exert significant control over the activities of both banks and strategically important industries
- Banks must in all cases demonstrate that the activities they engage in are both socially useful and in line with government investment guidelines
- Banks and corporations become proxies for economic competition between nations
- Cross-border acquisitions come under tremendous scrutiny and essentially become impossible in some cases (e.g. Chinese buying US company)
- Orderly currency systems break down and trade is highly disrupted

7%

Disparate views

The findings revealed a broad spread in what participants believe is the most likely direction for their sector, with no single scenario in any of the four categories gaining more than around 40% of the vote (see table on page 6). This wide range of 'bets' suggests that banks could strike off in a number of different directions over the next few years.

The findings also highlighted a number of significant regional and national differences over the rise of the emerging markets. In particular, more than 50% of bankers in the US and UK believe that the West and its financial institutions will continue to dominate global banking, compared to 40% overall (selecting scenario one or two). 'Things will settle and the US will continue to lead the way,' said a participant. Whether their confidence in the continued pre-eminence of Western banking is justified is one of the central questions raised by our analysis. Only 2% of US and UK

bankers could foresee a future in which the SAAAME forms a globally dominant and largely self-sufficient trading bloc, from which they are effectively locked out (selecting scenario five). This compares to 21% of bankers in India and 15% in Brazil who believe this is the most likely scenario, though interestingly most Chinese participants believe that banking will continue to be a Western-led industry.

It's also notable that US and UK participants have the least concerns over the potentially destabilising impact of pressure on resources or the possibility of greater government control over pricing, lending and cross-border investment. Regional and national differences tended to be less marked in relation to demographic shifts, though France did stand out as being more relaxed about the impact of an ageing population than other developed nations, Germany in particular.

Dealing with the impact

Forward thinking industry leaders recognise the scale of the challenge demands urgent and decisive action.

In the lead up to the financial crisis, there may have been a tendency among Western banks to follow the pack into areas that appeared to offer considerable revenue and return. The bubbles that built up around sub-prime lending were a prominent and ultimately highly damaging instance.

However, our survey finds many different perspectives on what lies ahead. Some banks might want to cover off different scenarios and hedge their bets by pursuing a diverse array of strategic options. However, with capital constraints mounting and talent at a premium, this scatter gun approach is simply not feasible. Even if the resources were available, organisations recognise that they can no longer afford to be all things to all people ('ubiquity').

The need for clear direction and specialisation means that successful groups will be ever more ruthless in the defence and optimisation of their core franchise ('precision'). The key is being able to identify the strengths within your business that would enable you to establish a leading position in this evolving landscape and then communicating a clear and compelling strategic rationale to your investors and your people. While some of the key decisions will be taken now, it will clearly take time to put in place the necessary talent, acquisition and operational capabilities needed to cement your competitive position. For many banks, this will require a shift from quick transactional returns towards a longer term perspective on value creation.

'In the landscape of extinction, precision is next to godliness.'

Samuel Beckett

Making sense of an uncertain future

We're working with a number of banks to judge the impact of the mega trends shaping their industry and where and how they can compete most effectively. If you'd like to discuss any of the issues raised in this flyer please contact:

Nigel Vooght

Partner and Global Financial Services Leader
PwC UK
Tel: +44 20 7213 3960
Email: nigel.j.vooght@uk.pwc.com

Andrew Dawson

Lead author – Project Blue
FS Strategy Group
PwC UK
Tel: +44 20 7804 0130
Email: andrew.j.dawson@uk.pwc.com

Andrew Nevin

Lead author – Project Blue
FS Strategy Group
PwC UK
Tel: +44 20 7212 2242
Email: andrew.nevin@uk.pwc.com

[*www.pwc.com/financialservices*](http://www.pwc.com/financialservices)

© 2011 PricewaterhouseCoopers LLP. All rights reserved. In this document, "PwC" refers to PricewaterhouseCoopers LLP (a limited liability partnership in the United Kingdom), which is a member firm of PricewaterhouseCoopers International Limited, each member firm of which is a separate legal entity.