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Transforming European banks: time for radical change

To reach their full potential European banks must urgently address several formidable challenges: credit, cost, consolidation, tech and ESG

PwC

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Contacts

France

Nicolas Bourdier
Partner,
PwC France
+33 6 68 77 83 69
nicolas.bourdier@pwc.com

Olivier Muller
Director,
PwC France
+33 6 30 67 49 11
olivier.muller@pwc.com

Germany

Nael Amin
Manager,
Strategy& Germany
+49 171 3587459
nael.amin
@strategyand.de.pwc.com

Felix Becht
Director,
Strategy& Germany
+49 170 2238409
felix.becht
@strategyand.de.pwc.com

Robert Bischof
Partner,
Strategy& Germany
+49 175 5601990
robert.bischof
@strategyand.de.pwc.com

Thorsten Egenolf
Senior Manager,
PwC Germany
+49 171 3635428
thorsten.egenolf@pwc.com

Clemens Koch
Partner,
PwC Germany
+49 171 1995051
clemens.koch@pwc.com

Dennis Kraus
Director,
Strategy& Germany
+49 170 2238458
dennis.kraus
@strategyand.de.pwc.com

Dr. Peter Gassmann
Partner,
Strategy& Germany
+49 170 2238470
peter.gassmann
@strategyand.de.pwc.com

Dr. Sebastian Marek
Director,
Strategy& Germany
+49 170 2238975
sebastian.marek
@strategyand.de.pwc.com

Marwin Schmidt
Senior Associate,
PwC Germany
+49 170 2215757
marwin.x.schmidt@pwc.com

Chris Sur
Partner,
PwC Germany
+49 171 4991100
christopher.sur@pwc.com

Dr. Philipp Wackerbeck
Partner,
Strategy& Germany
+49 170 2238659
philipp.wackerbeck@
strategyand.de.pwc.com

Italy

Gabriele Guggiola
Partner,
PwC Italy
+39 346 507 9317
gabriele.guggiola@pwc.com

Gladiola Lilaj
Senior Manager,
PwC Italy
+39 328 552 4740
gladiola.lilaj@pwc.com

Pier Paolo Masenza
Partner,
PwC Italy
+39 348 250 5003
pierpaolo.masenza@pwc.com

Luxembourg

Rima Adas
Partner,
PwC Luxembourg
+352 621 332 101
rima.adas@pwc.com

Netherlands

Roderik van Houtert
Director,
Strategy& Netherlands
+31 6 20715701
roderik.v.houtert
@strategyand.nl.pwc.com

UK

Mark Batten
Partner,
PwC UK
+44 7740 242449
mark.e.batten@pwc.com

Isabelle Jenkins
Partner,
PwC UK
+44 7711 773030
isabelle.jenkins@pwc.com

John Lyons
Partner,
PwC UK
+44 7590 351933
john.r.lyons@pwc.com

Michael Magee
Partner,
PwC UK
+44 7764 235517
michael.magee@pwc.com

Switzerland

Daniel Zeiter
Director,
Strategy& Switzerland
+41 79 779 01 75
daniel.zeiter@pwc.ch

ABOUT THE AUTHORS

Dr. Philipp Wackerbeck is an advisor to executives in the financial sector for Strategy&, PwC's strategy consulting business. As the Global Head of Financial Services for Strategy&, he regularly advises clients on important strategic projects like large-scale transformations and particularly in deals related projects including M&A, growth and market entry strategies, reorganizations, carve outs and debt and equity transactions. Additionally, he has in-depth knowledge in the risk, capital and regulations space. Based in Munich, he is a partner with Strategy& Germany.

Rima Adas is specialised in the Financial Services Industry with a focus on Banking and Capital Markets. She has broad experience in auditing banking groups, financial professionals and asset managers and advising them regarding internal controls. She leads PwC's Financial Services practice in the EMEA region and coordinates our services offering which include mainly audit, consulting, tax and legal, and corporate finance services, and ensures alignment of our services with our clients' needs. Based in Luxembourg, she is a partner with PwC Luxembourg and member of the Country Leadership Team of PwC Luxembourg as Deputy Territory Senior Partner.

Julian Wakeham focuses on supporting business and operational transformation and works from strategy through design and execution. He has a broad knowledge of wholesale banking and capital markets, with deep domain and industry knowledge around transaction banking. He leads PwC's Financial Services EMEA Consulting business. Based in London, he is a partner with PwC UK.

Isabelle Jenkins leads the Financial Services practice in the UK, bringing knowledge and experience from more than 25 years across regulation, control, operating model, cost management and technology. She has worked with key banking clients and European governments, including five years as interim CIO at Lehman Brothers International Europe post its administration. Based in London, she is a partner with PwC UK.

Pier Paolo Masenza is a partner with PwC based in Rome. He leads PwC's Financial Services practice in Italy as well as the Value Creation Platform at EMEA level. His focus area includes M&A, due diligence and restructuring services assisting - both buy-side and sell-side - Italian and international companies, banks and investors of the highest importance, both as a financial and industrial advisor.

EXECUTIVE SUMMARY

European banks face yet another period of uncertainty. They have been remarkably resilient in the face of the Covid-19 pandemic, but will continue to be affected by the variable pace of growth in the global and European economies. Both national governments and the European Central Bank (ECB) have stepped in with a battery of extraordinary actions to soften the economic blow of the pandemic, but as these measures are phased out, more businesses will go under and unemployment will remain stubbornly high.

This will force some banks to book higher loan loss provisions and deplete capital buffers, and could ultimately affect their ability to provide enough financing to support economic recovery.

The pandemic has exacerbated other challenges already affecting European banks, whose share prices have lagged behind the wider market for more than a decade despite a strong start to 2021. Costs are simply too high in an era of zero or negative interest rates, and bank returns are below their cost of capital. The Covid-induced economic contraction has put even more pressure on the bottom line, and the demand for loans remains uncertain, according to the ECB[1].

Banks in Europe also remain subscale compared to their peers in other parts of the world, although there are signs of an appetite for consolidation after the ECB provided more incentives for banks to merge.

While the rebound in sector share prices in 2021 is highly encouraging, banks cannot afford to be complacent. The challenges they face are formidable, and to emerge stronger from the crisis, banks must radically transform their cost base, streamline their operations and consider mergers, including cross-border deals, more seriously. Large-scale change is required, and it must be based on strategic positioning – what are the differentiating capabilities that set a bank apart and will be the focus of future investment? Which products and lines of service are no longer relevant or profitable and should be stopped?

In addition, the scale of the technological transformation of financial services over the past decade cannot be overstated, and banks can no longer take customer loyalty for granted amid competition from FinTech and BigTech players. This change requires all bank operations to be run from a solid digital platform. Banks will also have to provide environmental, social and governance (ESG) disclosures to build the sustainable models demanded by customers, shareholders, regulators, employees, ratings agencies and other stakeholders.

The stakes are high. European banks will struggle to catch up with their stronger US and Asian peers without radical change. Banks must act now to address these challenges head-on through a profound transformation of their business models. The goal must be to close the yawning gap between bank returns and their cost of equity.

1 Source: https://www.ecb.europa.eu/press/pr/date/2021/html/ecb.pr210519~bd45e646c7.en.html

In this study and a forthcoming series of detailed deep dives, we set out actions to take in at least **five key areas**, all of which directly impact bank profitability. None of these areas are new for banks, but they must be revisited and reviewed rigorously with a view to taking decisive strategic action:

1 Credit	Understand the dynamics of the recovery across different markets and industries to prepare for any rise in loan defaults by identifying the key risk drivers, and devise strategies to conserve capital. Reassess risk appetite across different sectors and asset classes.
2 Costs	Plan a strategic review that radically transforms the business, with potential to reduce the cost base by up to 40 percent. Reallocate scarce resources to more profitable lines of business.
3 Consolidation	Undertake a thorough analysis of potential transactions ahead of an expected wave of deals.
4 Tech	Develop a digital platform that is scalable and offers customers personalized digital services, while making the organization more flexible and agile.
5 ESG	Craft a truly sustainable business model that measures success with KPIs that are part of overall executive incentive schemes.

Taken in isolation, each of these areas could lead to significant change in the way a bank operates. In practice, they are interdependent and ideally should be considered holistically. For example, a substantial cost transformation may require an overhaul of technology systems to make them scalable. Even a radical cost transformation may not be enough to really shrink the cost-to-income ratio, and so banks might have to consider mergers. Adding scale might also give banks the firepower to undertake billions of euros' worth of additional investments in technological transformation.

All these changes will also require bank employees to adapt their skills to new ways of working. Bank executives must put their people first if they want engaged and motivated employees.

A real transformation means banks must move beyond tactical measures. To be truly effective, both the boards and the management teams of banks must be committed to taking bold strategic decisions and implementing them effectively, throughout their organizations.

"European banks must act now to close the long-standing gap between their earnings and the cost of capital by radically rethinking their business strategies and comprehensively repositioning themselves, particularly in the areas of credit, cost, consolidation, technology, and ESG."

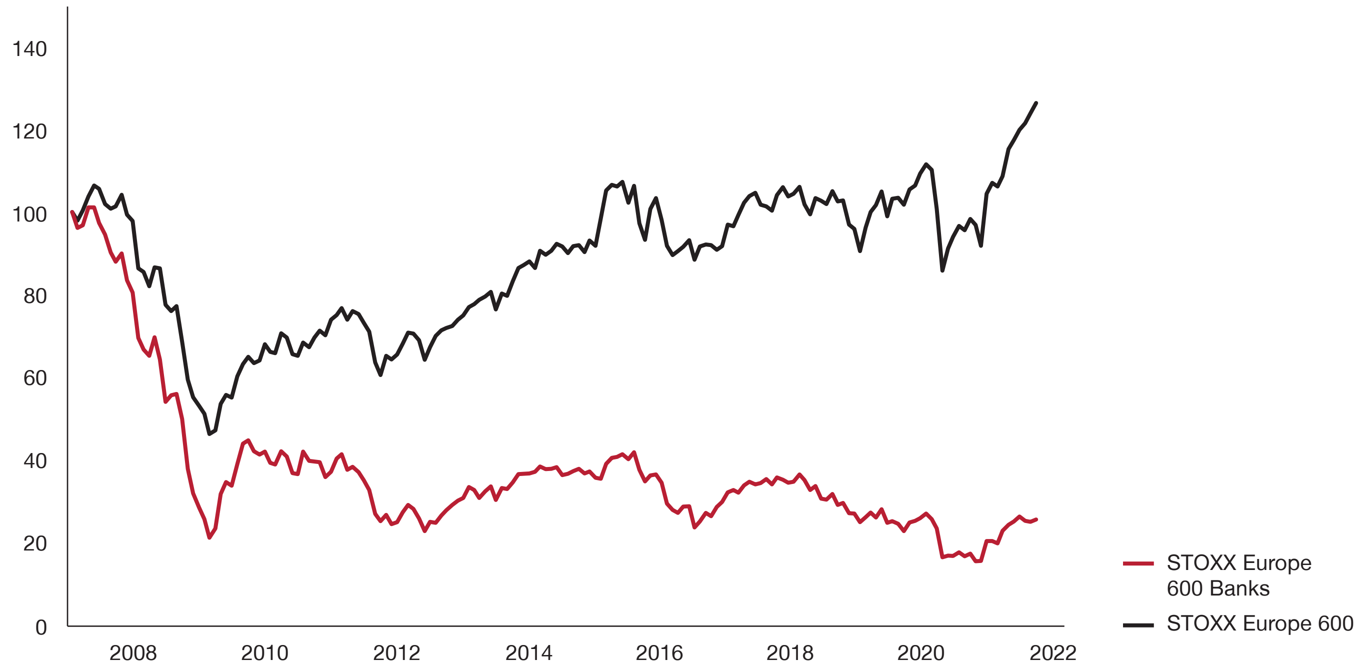
Dr. Philipp Wackerbeck

Market overview: the state of play of European banks

Eurozone banks are today much better prepared to deal with shocks than during the 2008 financial crisis. They entered the Covid-19 pandemic with relatively few bad loans, strong capital ratios and plenty of liquidity. Following years of repairing balance sheets and increasing capital buffers on the back of Basel reforms, Europe's largest banks had a generous cushion to fall back on.

Despite this progress, however, and the strong rise in market sentiment in 2021, shares in the sector have fallen dramatically since 2008. Eurozone banks have lower returns than most global peers due to a combination of ultra-low interest rates, stagnant growth and structurally high costs. Little wonder the European banking sector was a market laggard prior to the onset of the pandemic (*see Exhibit 1*).

EXHIBIT 1
European banks financial performance (31.01.2007 - 31.08.2021)



Source: PwC and Strategy& analysis

Investor confidence slumped during the Covid-19 crisis, driving stocks to record lows. Bank shares have rebounded from the low point of September 2020, driven by a more optimistic economic outlook and fewer loan loss provisions than expected, as well as booming capital markets activity. However, profitability remains weak relative to peers in the US and Asia (*see Exhibit 2*).

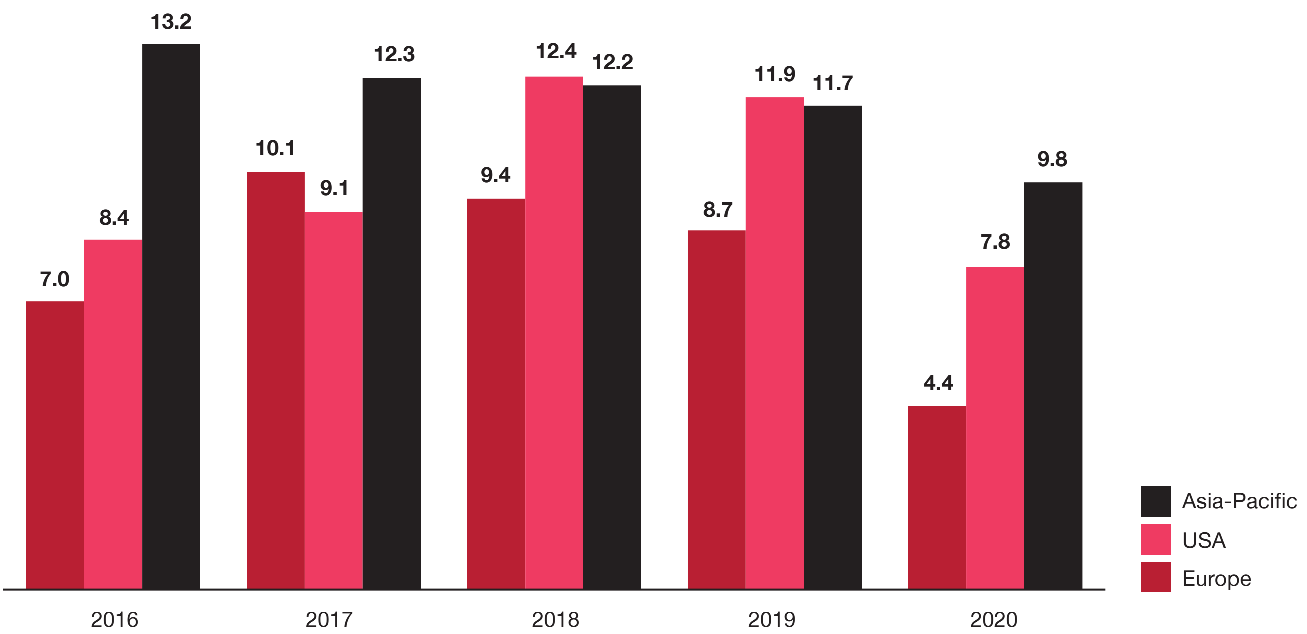
Although the ongoing rollout of vaccines is helping the economy return to normal, the stilted pace due to shortages in vaccine production, as well as new variants of the virus, make the recovery uncertain. The outlook has brightened, but euro area GDP is still 5.5 percent below its pre-pandemic level[2], and millions of jobs that were lost during the pandemic have not yet been recovered.

Against this backdrop, the case for transformation is unarguable, and below we look at how banks can tackle several key challenges to unlock profitable growth.

2 Source: https://www.ecb.europa.eu/press/inter/date/2021/html/ecb.in210526~99707ed7f5.en.html

EXHIBIT 2

Return on Equity (31.12.2016 - 31.12.2020)



Source: PwC and Strategy& analysis

1. Credit: using balance sheets more flexibly

The Covid-19 pandemic brought economies around the world to a virtual standstill in the spring of 2020. Governments jumped in with emergency packages designed to support jobs and shield their economies from the worst of the fallout. The ECB deployed a series of exceptional measures designed to help banks maintain credit to companies and keep financial markets open. It also relaxed rules for provisioning bad loans.

This unprecedented policy response allowed companies to survive temporarily and banks to maintain the flow of credit to the economy. The stock of non-performing loans across Europe edged up just 20 basis points in 2020 to 2.9 percent based on our research.

Yet the actions have also hidden the true state of bank balance sheets, and European bank regulators have warned of an expected deterioration in credit quality. As emergency measures run out, more companies will default and force banks to recognize the losses.

The pandemic has had an uneven effect across sectors, with technology and some consumer goods businesses thriving while other industries including hospitality, non-food retail, trade and transport have been hit hardest. Commercial real-estate prices have also corrected, and a further decline is a risk, according to the ECB[3]. The sector accounts for 7 percent of non-financial private-sector loans. It has also had an asymmetric impact across different countries, with those that had to put in place lengthy lockdowns or that are more reliant on the most affected sectors suffering most.

The consequences for banks will therefore vary, depending on the individual resilience of earnings and state support. The removal of relief measures isn't likely to pose major problems for the largest banking groups, since these institutions are diversified and generally well capitalized. However, smaller lenders with more concentrated asset portfolios may face difficulties.

Given the uncertainty surrounding the length and scale of the economic fallout, bank executives may be tempted to wait and see. This would be a mistake. The expected rise in NPLs is likely to eat into capital buffers and banks will have to take steps to protect their balance sheets. The sooner they begin, the better prepared they will be for a rise in defaults. There is another reason for expediency: there are investors willing to buy riskier or distressed assets and banks should take advantage of this market window. They will need to reassess their risk appetite across different sectors and types of assets.

3 Source: The latest Financial Stability Review: https://www.ecb.europa.eu/pub/financial-stability/fsr/html/ecb.fsr202105~757f727fe4.en.html

So where to start? Banks should undertake a strategic review of their balance sheets and internal processes in order to minimize the impact of any deteriorating credit quality. This review should consider three major components:

Portfolio review – Banks should undertake a detailed analysis of the quality of their loan portfolios, including stress tests. This will enable them to identify key risk areas under different scenarios and adjust their provisioning models accordingly.

Capital conservation – Banks should consider different alternatives to reduce their exposure to souring loans, as well as alternative sources of funding that reduce the size of the balance sheet. These include developing a hedging strategy or structuring loan sales.

Governance – Establish clear processes for assessing loan risk, from client-facing employees to recovery units. Adjust early warning systems and governance systems to be more robust and forward-looking, for example by using real-time indicators.

Another significant issue for banks is that the Covid-19 crisis and the lack of clarity over the risk provisions that will ultimately be needed (i.e. capital) have created uncertainty over whether banks have too much or too little capital.

What is needed is a more flexible approach to how loans are originated and held, especially in such volatile times. This will require a structural and far-reaching transformation of the credit business model: moving away from a pure buy-and-hold lending approach, strengthening credit market-making capabilities (including trading/ structuring loans), and partnering with institutional investors to increase balance sheet velocity – banks would do more origination, but hold fewer loans. Of course, to enable this there also need to be changes to new business steering and incentive systems. Achieving this transformation and moving out of their structural interest margin dependency is a key challenge for banks.

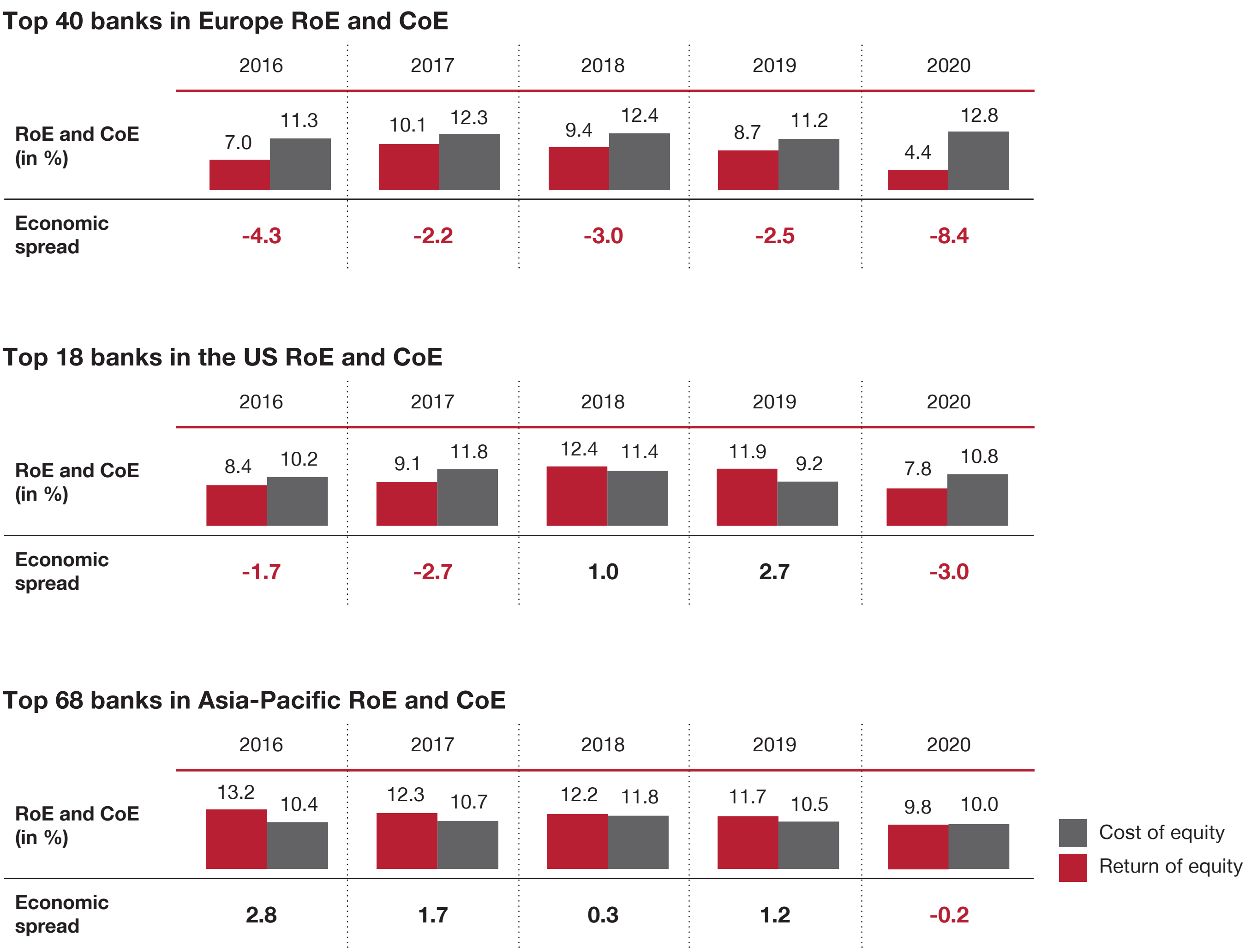
Such changes also require additional investment, for example to strengthen new client management and loan structuring. To find the funds to support transformation in their business model, banks will have to develop a leaner cost structure, which we will look at in detail below.

2. Costs: time for a radical rethink

Eurozone banks have struggled with weak profitability for years. Zero and negative real interest rates have eroded net interest income, while an increased regulatory burden has pushed up an already bloated cost base. New and nimble challengers have taken market share. As a result, banks' returns have consistently been below their cost of equity, long before the pandemic hit in early 2020. The contrast with their peers across the Atlantic is stark. Asia-Pacific banks are even better positioned, showing mostly a positive economic spread between return on equity and cost of equity (*see Exhibit 3*).

EXHIBIT 3

International comparison of economic spread between Return on Equity and Cost of Equity



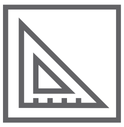
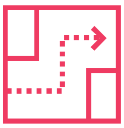
Source: PwC and Strategy& analysis

One of the few levers banks can pull to boost the bottom line is to cut costs. For years, financial institutions have slowly upgraded their legacy systems, closed branches and exited low-return businesses, but these cuts have not gone deep enough. **Banks cannot afford to tinker around the edges if they want to adapt to the current landscape; they must rethink their entire operating model and become future-proof.**

Bank executives should conduct a radical strategic review while simultaneously focusing on short-term tactical and mid-term operating improvements. This **three-tiered simultaneous approach** (*see Exhibit 4*) has the potential to cut up to 40 percent of the cost base over three to four years, with most of the results achieved in years two and three.

EXHIBIT 4

Three-tiered simultaneous approach

Approach	Timing and savings[1]	Description
 Radical redesign operating model	Long-term ~30-40%	• These initiatives require a fundamental rethink of the operating model, often involve extensive changes to the organization and can require up to four years to put in place • Examples include portfolio rationalization, end-to-end process digitization and a streamlined IT landscape
 Streamlining operating model	Mid-term ~15-20%	• Selective measures that increase profitability in parts of the business in the mid-term (two to four years) • Changes to processes that require a medium-term timeframe • Examples include product rationalization, spans and layers, and process automation
 Tactical measures	Short-term ~5-10%	• Tactical measures that can be implemented quickly and do not require a deep transformation of the business model • These measures can fund the longer term initiative • Examples include discretionary spend review, salary freezes, applying rigorous zero-based budgeting

1 Savings are not incremental, but cumulative across the three elements of the approach
Source: Strategy& analysis

However, boosting returns requires more than simply taking an axe to costs. Blunt cost reduction won't work in areas such as people transformation, investments in technology or increasing the efficiency of risk-weighted assets. Banks must learn how to reallocate scarce resources toward more profitable segments to improve return on equity.

To kick off this process, bank leadership teams should first determine their strategic (differentiating) positioning and capabilities relative to peers, including the new challengers. This will determine the actions to be taken and, following the strategic review, banks can execute all three phases above in parallel (*see Exhibit 5*).

EXHIBIT 5
Indicative approach for strategic cost reduction

Source: Strategy& analysis

> "Operational costs of banks can be reduced by up to 40% within three to four years – most savings can be already achieved in the first two to three years."
>
> **Julian Wakeham**

Facing up to necessary changes

Putting in place a radical operating model redesign will require bank executives to take bold and complex decisions. For example, they may need to rationalize their product offering and withdraw unprofitable lines. Banks will continue to reduce the number of physical bank branches and simplify their network, but retail managers will alternate between remote working and meeting clients in the field. Other significant changes may include (*see Exhibit 6*):

EXHIBIT 6

Radical redesign operation model

Source: Strategy& analysis

Our experience shows that an effective cost transformation requires a commitment from day one, with clearly articulated goals and continued engagement with key stakeholders. It will affect the entire bank. Management teams should focus on getting the whole organization behind the transformation and engage employees. Once the bank has successfully launched the strategic review, it will be in a much stronger position to participate in M&A and asset sales or purchases.

3. Consolidation: better together

The European banking market remains far too fragmented. Even before the pandemic, the case for consolidation was clear, with many financial institutions struggling to earn their cost of capital, and increasing competitive pressures from larger international banks capable of making large-scale technology investments. Yet mergers have been stymied for many reasons, including the lack of progress toward a full European banking union.

However, the stars are aligning for consolidation in the European banking market within the next 12 to 18 months. First, the pandemic has further hit profitability and mergers are an obvious means to save costs. Second, the changing regulatory landscape could help spur further deals. In January 2021, the ECB published a guide on consolidation that includes new rules that make mergers more attractive in Europe[4]. Importantly, a bank buying another at a price below the value of the assets can generate a capital gain known as “badwill.”

This paper gain can be used to pay for integration costs and increase provisions, making the economics of a deal more attractive in a crisis and recovery environment. For example, Intesa Sanpaolo’s takeover of local Italian rival UBI Banca generated €2bn in badwill that was used to cover integration costs and additional loan loss provisions. In the case of Caixabank’s takeover of Bankia, the figure was €4.3bn[5].

In addition, the ECB will not automatically impose higher Pillar 2 capital requirements, but instead base it on the actual risk profile of the combined entity by taking an average of both banks’ standalone capital requirements as a starting point.

In the short term, consolidation will likely focus on in-market consolidation driven by cost savings (and badwill), as seen in the recent deals in Spain and Italy. These transactions are easier to execute and have higher synergy potential than cross-border deals. The latter are more complex from a regulatory perspective, given the absence of a true European banking union, which means transactions are beholden to different national legislation across the EU.

Once domestic consolidation has right-sized local markets in terms of the number of banks needed in the country and their cost bases, we expect banks will also show an increased appetite for cross-border transactions. As cost synergy potential is lower than in the case of domestic deals, cross-border mergers will be more driven by strategic considerations around geographical coverage, advanced wholesale banking capabilities, and scale for technology investments and operations.

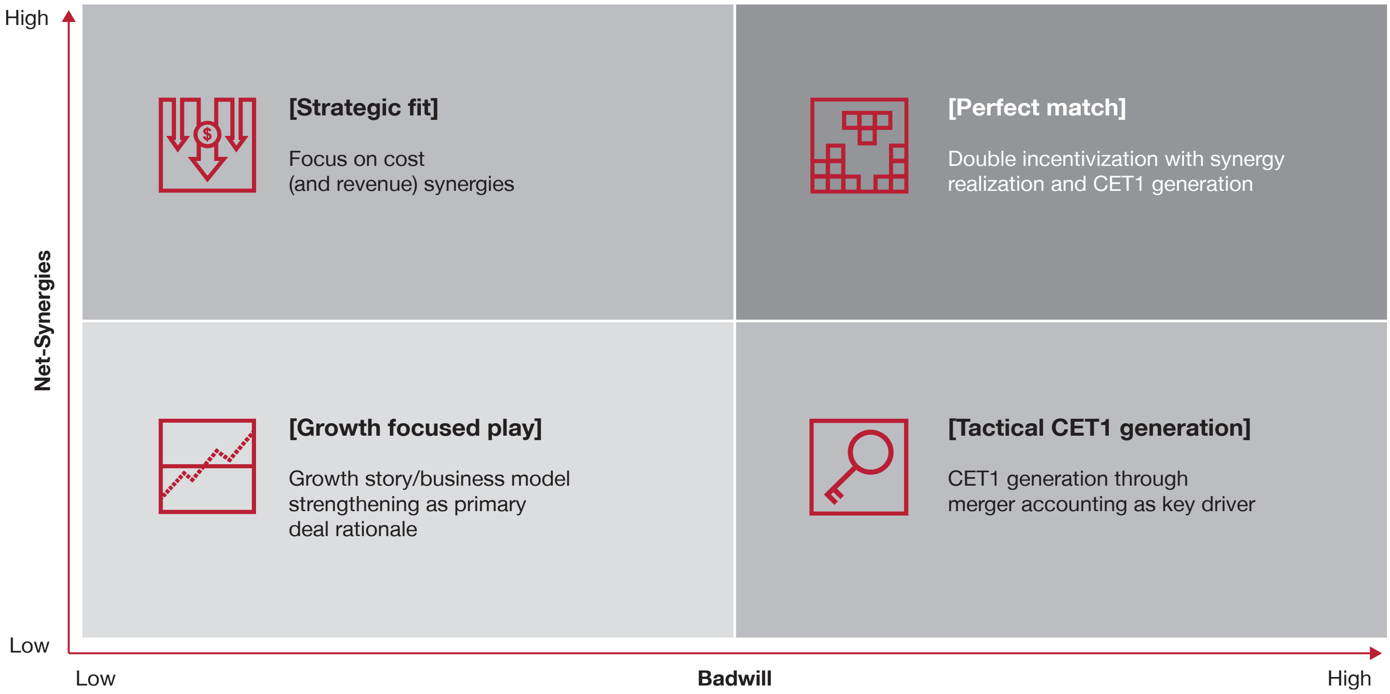
4 Source: https://www.fitchratings.com/research/banks/ecb-lays-ground-for-further-eurozone-bank-consolidation-14-01-2021
5 Source: https://www.caixabank.com/deployedfiles/caixabank_com/Estaticos/PDFs/Accionistasinversores/Informacion_economico_financiera/210506_Webcast_1T21_en.pdf

> “Following deals activity in 2020 in some Eurozone countries, the stars are aligning for further consolidation in the banking sector. Though domestic mergers are more likely in the short term, stronger banks may contemplate cross-border tie-ups.”
>
> **Pier Paolo Masenza**

The ideal transaction would have strong potential for synergies and generate a high amount of badwill (*see Exhibit 7*):

EXHIBIT 7

Deal attractiveness framework (deals among banks)



Source: Strategy& analysis

Synergies will be delivered best if the combined bank has a strategically superior capabilities system compared to each of the standalone banks. Hence, when assessing potential combinations, banking executives need to go beyond the financial impact estimates and ask the question: how will the merged bank be more successful with our clients and which new capabilities will help us beat competitors? The answer to this question will determine the viability of cross-border transactions.

There are also technicalities that can alter the economics of a transaction. For example, badwill might be subject to tax depending on the local legislation.

In short, the most critical step of a successful deal is the initial analysis. In addition to the considerations above, during this pre-deal phase banks often overlook key components of the value creation analysis. Examples include the role of labor unions in certain jurisdictions, or adjustments that need to be made to the fair value of assets in merger accounting, which can often cause significant swings in capital levels.

When banks are analyzing potential deals, there are **three key areas** to focus on to achieve a successful outcome:

- Timing of the transaction – deals should be contemplated from a position of strength and minimum market volatility.
- Thorough strategic and financial analysis of potential deals with a focus on key technicalities that can alter deal economics. Strategic options are highly dependent on the starting point of each individual bank.
- Efficient execution – banks must have a strong team in place with clear responsibilities to manage all phases of the deal, from pre-transaction analysis to the negotiations and post-deal execution.

With a larger consolidated entity, a substantial investment in technology is easier to bear and is a key enabler for an overall tech transformation.

4. Tech: fast and adaptable

Technology has dramatically changed the banking landscape in the past decade, with BigTech players and smaller FinTech firms clawing market share from incumbents. New and nimble competitors are emerging regularly. These challengers have more efficient and cloud-based platforms, allowing them to add on new products and services demanded by increasingly digitally oriented customers. They can keep costs low and challenge bank borrowing rates and fees. FinTechs are also generally better at innovation, while BigTech firms can offer financial services to their existing large customer bases.

Meanwhile, traditional banks have struggled to compete, held back by their legacy infrastructure and a bloated cost base. The need to make substantial investments in their technology backbone is another reason that the radical action on cost outlined above is a vital part of any transformation, as well as considering mergers to gain economies of scale.

Banks cannot afford to take their customer loyalty for granted. Covid-19 has only accelerated the shift to online banking and customers have come to expect the same personalized mobile solutions from their banks as in other areas of their lives. They want to be able to switch easily between online banking, using an app or visiting a bank branch. At the same time, banks continue to navigate an increasingly complex and costly regulatory regime.

Adapting to the fast-changing environment is a question of survival for European banks. There are essentially two main pillars around which banks can build a successful foundation for a tech transformation. First, they must continue to digitize their own platforms and modernize IT systems. Most banks have legacy platforms that have been built piecemeal over decades and need an overhaul. A cloud-based platform will allow banks to pick and choose vendors, making it more flexible, secure, and importantly, scalable.

A more streamlined and data-rich IT platform will also enable banks to anticipate the demands of their increasingly digital customers and offer them highly personalized and relevant services.

Second, organizations must also adapt to new ways of working, including more staff working remotely, that will require more agility and digital skillsets from employees, and create environments that allow innovation to flourish. According to PwC and Strategy& analyses, applying an “agile” method of working can increase efficiency by 20 percent and productivity by around 30 percent, and drives cultural change. Ultimately, a more adaptive organization will empower employees to improve the customer experience. To speed up the rollout of new features, banks must look to external partnerships and collaboration with new cloud-based providers.

“In order to further digitize their own platforms and modernize their IT systems, banks should make their business more flexible, secure and, most importantly, scalable with the help of clouds.”

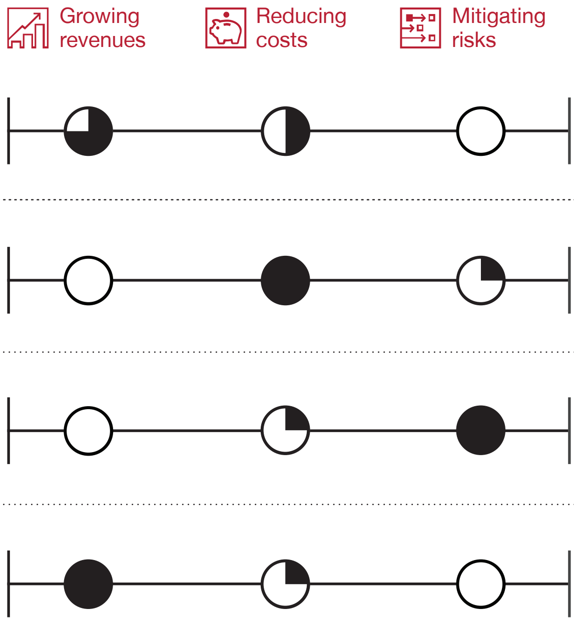
Isabelle Jenkins

Once the bank has the right foundation, it can focus on **four key tech-driven areas** (*see Exhibit 8*):

EXHIBIT 8
Key tech-driven areas

Focus areas	What is it about
Personalized services	• Establish highly personalized digital interactions • Uncover insights from customer data
Simplification and optimization	• Rethink and redesign existing processes • Deploy technologies into operations for significant cost and time savings
Proactive threat management	• Anticipate new threats before they occur • Respond in near real time
Evolving business models	• Introduce new methods of delivering services • Move from traditional services to services beyond banking

Where is the impact



Source: PwC and Strategy& analysis

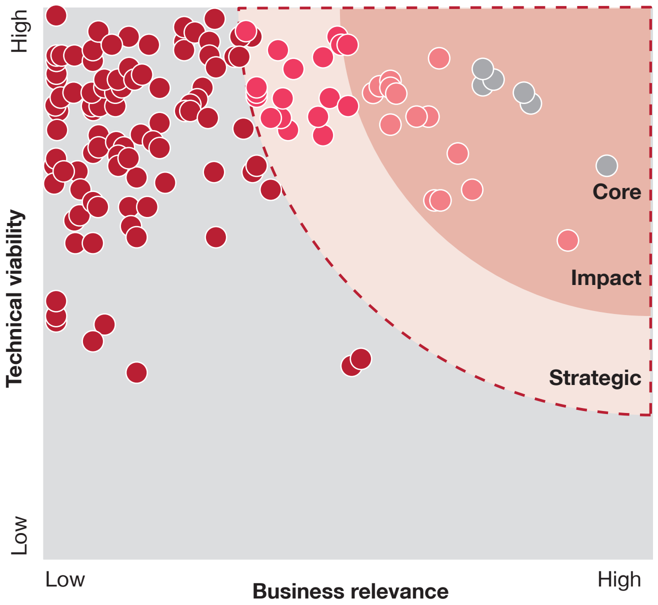
New and potentially highly disruptive technologies are constantly appearing. Keeping track of all these emerging trends is a complex and time-consuming endeavor, and some show more promise in banking than others. Banks need to evaluate which ones are key for making progress in their digital transformation. **Core technologies** including artificial intelligence (AI), cybersecurity and Big Data already have a high degree of impact across the sector and are necessary to ensure banks do not fall behind. At the same time, banks need to actively consider **emerging technologies** to ensure they are prepared for potential future trends. Finally, banks need to have an eye on **visionary technologies** such as deep learning as part of their long-term technology strategy.

PwC's Technology Heatmap has assessed over 265 technologies and can help banks analyze the viability and relevance of different technologies for their digital transformation (*see Exhibit 9, page 18*).

An agile technology system will also be an essential tool for banks to fulfill the wave of ESG requirements coming down the line, and to customize new green products.

EXHIBIT 9

Emerging technology topics: **Financial Services**



Core technologies

Emerging technologies that have the biggest impact across selected business trends

- Intelligent process automation
- Artificial intelligence (narrow)
- Predictive analytics
- Machine learning
- Identity management
- Robotic process automation

Impact technologies

Emerging technologies that have broad applications across selected business trends

- Content analytics
- Advanced risk models
- Proactive software agents
- Simulation modeling
- Risk-based security and self-protection
- Blockchain
- Customer experience management
- Disintermediation
- Fraud management
- Activity streams
- Prescriptive analytics
- Service orchestration
- Digital twin
- Intelligence engines
- API orchestration

Strategic technologies

Emerging technologies that have more narrowly defined use cases or are a long-term technology strategy

- Natural language processing
- Data scientist
- Composite applications
- Smart contracts
- Deep learning
- On-demand business and technology services
- Anything-as-a-service
- Chatbot
- Agile development
- Microservices architecture
- Omnichannel integration
- Natural language understanding
- Data lake
- Internet of things
- Behavioral analytics
- Tokenization
- Hybrid cloud computing
- Loyalty and rewards
- On-demand scalability

Source: PwC analysis

5. ESG: banking with purpose

Eurozone banks are catching up fast with the sustainability agenda. Governments around the world have committed to reduce carbon emissions, driving a surge of interest in clean energy. The European Commission's ambition to reach net zero emissions by 2050 will require billions of euros to finance sustainable energy projects.

The Covid-19 pandemic has only accelerated the shift: more than one-third of the EU's recovery funds have been set aside to finance the green transition[6]. The ECB's president, Christine Lagarde, announced a shift toward a greener monetary policy in January 2021.

As financial intermediaries, eurozone banks are in a unique position to facilitate this transition. Besides regulators and politicians, they are also feeling the pressure from other stakeholders. Shareholders are demanding businesses step up on issues beyond climate, including diversity. At the same time, customers and employees expect companies to play their part in fighting climate change and drive social change. There is little tolerance for companies simply paying lip service or exaggerating their ESG credentials in so-called "greenwashing."[7]

The increasing interest in sustainable finance and ESG is clear, but how far should banks go in incorporating ESG to their strategies? Banks currently fall into three categories when it comes to their overall strategy:

The **Doubter** considers ESG to be a box-ticking exercise and a regulatory burden. It meets minimum regulatory standards, but does not incorporate sustainability into strategy development.

The **Pragmatist** recognizes that ESG can influence performance and targets quick wins to meet stakeholder requirements. It assigns some weight to KPIs in management incentive schemes and gives responsibility for ESG implementation to senior management.

The **Strategist** fully integrates sustainability into its business model and considers ESG part of the bank's purpose. It sets ambitious sustainability targets with responsibility at board level.

6 Source: https://ec.europa.eu/commission/presscorner/detail/en/ip_20_2397
7 Source: https://www.sec.gov/news/press-release/2021-42

We believe most banks should aim to be strategists. If done diligently and with conviction, ESG is an opportunity to enhance reputation, reduce lending risk and potentially improve returns. For example, some banks have set strict targets to reduce exposure to carbon-intensive activities like coal mining. Many financial institutions have signed up to the Equator Principles[8], a set of guidelines designed to assess and consider environmental and social impacts in projects.

To achieve this, ESG must be a clear priority for the board and the management team. It should not be limited to climate concerns, but incorporate social and governance priorities as well. Social issues, ranging from labor relations to supply-chain standards, have lagged “E” and even “G” factors, but social responsibility has come under increased scrutiny during the pandemic, especially regarding the treatment of employees.

The first step to a holistic ESG transformation is understanding that it will impact the entire bank. ESG affects every aspect of doing business – from product design to data management. We recommend that management teams devise a roadmap for incorporating sustainability into the bank’s strategy, business goals and organizational culture. This involves defining a clear set of KPIs for business units and tracking ESG data to measure success.

Banks must also adopt a transparent approach for communicating these goals to their stakeholders, including a sophisticated reporting system to provide a measurable pathway toward their ESG targets. There is an avalanche of regulatory requirements around ESG, from the EU Taxonomy to adherence to European Banking Authority (EBA) standards.

8 Source: https://equator-principles.com/about/

“In light of current political and social developments, bank executives are well advised to make ESG a core principle of their strategic considerations. A sustainable strategy should include climate factors as well as social and governance priorities.”

Rima Adas

Conclusion

European banks have proved resilient in the face of the Covid-19 pandemic, but the need for transformation is as urgent as ever. The pace of the economic recovery remains uncertain, and the banking landscape continues to change rapidly. Rising costs and defaults will further erode profitability at a time when stakeholders are demanding businesses commit to sustainable business models.

What can banks expect if they successfully undertake this transformation? The goal must be to close the gap between returns and the cost of capital. In the short term, this means managing the risks associated with an uneven economic recovery on the loan book. That requires a more flexible approach to adjust how loans are originated and held, moving toward a more “asset light” model.

Banks must also undertake a radical review of their cost structure in a transformation that will affect every aspect of the bank. Cutting costs and improving returns would free up funds to make the investments in the technology needed to compete with BigTech and FinTech competitors, and meet customers’ new expectations when it comes to convenient and secure digital banking. These investments may require more scale and lead to more consolidation in the industry.

A more efficient cost structure would put banks in a stronger position to take advantage of these future consolidation opportunities. The ECB’s new guide has already encouraged domestic mergers in Italy and Spain, and banks should be actively considering cross-border transactions where scale or added capabilities offer a clear competitive advantage. Other banks may seek strategic alliances with rivals that have similar business models to combine them on a single platform, or pursue partial mergers.

ESG considerations must also be an integral part of any radical bank transformation. This is not just about meeting legal requirements and becoming carbon neutral, but rather understanding ESG as an opportunity to enhance reputation, de-risk loan portfolios, increase engagement with stakeholders and attract talent. Again, technology can play an important role in offering clients ESG-linked products and improving data disclosure.

Real change necessarily involves rethinking the entire business model, which will lead to a massive transformation within the workforce, in terms of working models and the skillsets required. The sooner eurozone banks begin their transformation, the sooner they can close their long-standing performance gap.

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