

The future of growth and the banking industry:

Adapt decisively to the disruption of everything

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Quick read

We surveyed over 350 U.S. banking executives to find out how they are shaping their firms to succeed in the future, looking in detail at how they plan to create, protect and transform value in an era of political uncertainty and technological disruption. Survey respondents were C-suite executives and senior director-level individuals from a range of banks, including corporate and investment banks, retail banks, wealth managers, and broker-dealers.

The research unearths a group of leading banks that are making bold decisions and reinventing themselves for the future. They are exploiting innovative technologies, mastering advanced data analytics and taking a more strategic view of risk. Companies are also evaluating the impact of political and regulatory change in the near-term that may affect long-term focus.

The gap between these leaders and other businesses will grow as technology widens the performance gap and makes it more difficult to catch up. If a company does not want to be stranded on the wrong side of that chasm, it must initiate far-sighted, strategic and profound change.

Introduction

In the complex environment that defines the banking industry, the simple fact remains that strong customer relationships are still the most important contributor to a bank's growth and long-term success.

But figuring out how to attract and retain valuable customers is a tricky business, especially in this time of transformational change in the financial services industry.

"We're seeing the first generation of true digital natives who can't remember a time before the internet. They have new expectations of their financial services providers," says Tom Joseph, a managing director in Grant Thornton LLP's Financial Services Advisory practice. "These customers are completely comfortable with digital banking, rarely visit a branch location and consider it a baseline expectation that their bank provides a mobile app." To serve them, institutions are reassessing their business models — from rethinking branch locations and services to investing in technologies to enhance digital services. And there's some urgency: Fintech firms are partners in the transformation as well as potential competitors.

Creating a refined or totally new business model includes a close look at the existing risk environment. Conducting business online requires controls that protect against the cyberthreats that inevitably accompany a move toward digital services and put client relationships at risk.

Banks are taking a fresh approach to capture and analyze customer data that yields insights on providing better customer service and anticipating future client expectations. Deep in the data sets that banks already have about their clients are untapped insights to build sustainable customer relationships.

Economic forces and the regulatory environment that governs the industry will play a role in how institutions structure their business models. The scope and the timeline for action remain unclear as interest rates climb slowly and the Trump administration explores relaxing federal regulations.



A wave of disruption

Banks realize that their business models must change, but should change be incremental or transformational? Many factors influence the decision.

Regulators, new competitors and — most important — customers will dictate the level of change. Fintech innovations offer great opportunities for banks to create new efficiencies, spanning areas such as payments, personal financial management, lending, investments and core banking.

Yet, as banks delve into these opportunities and choose technology solutions, they must focus on enhancing the customer experience. The game is changing fast, as fintech firms innovate the way banks adapt to changing customer demand.

Staying relevant

Bob Fehlman, senior executive vice president, CFO and treasurer at Simmons First National Corporation, says that banks are clearly focused on what the next generation of customers want. “These customers grew up with technology,” he says. “And they’re going to be a lot more receptive than even the current generation.” But choosing from the vast array of fintech solutions can be a daunting prospect. “One of the things we do is make sure that we’re not overreacting and jumping ahead of ourselves,” adds Fehlman. “But we don’t want to be on the tail end and become irrelevant to our customers.”

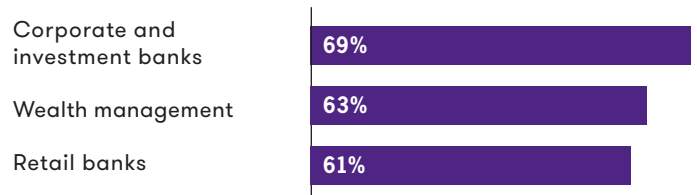
A move to the digital model

With a keen eye on changing customer preferences, banks are selectively partnering with fintech firms to gain technologies that complement, rather than displace, their current channels. Mobile banking is on the rise, and online customer service, powered by chatbots and artificial intelligence, continues to expand and improve.

The digital disruption has banks assessing whether the real estate footprints of their branch locations still make sense. As Figure 1 shows, institutions across the spectrum agree that all banks will offer digital channels.

Many banks are responding by closing branch locations and rethinking how they provide service in those they keep open. Tellers, armed with technology, are elevated to full-service bankers who can help customers with all their banking needs and raise the customer experience. “Customers are able to get full-service banking with a more personal relationship approach using new technology to its fullest extent,” says Fehlman.

Figure 1: Respondents who agree that all banks will offer digital channels.

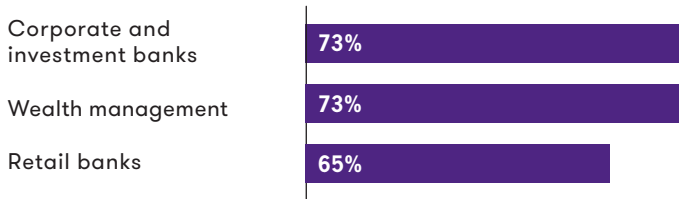


Fintech disrupts as much as it enables

Nearly two-thirds of survey respondents (64%) agree that traditional banks will face an increasingly competitive environment as players from outside the industry and fintech new-market entrants muscle in on their key customer segments.

The Office of the Comptroller of the Currency (OCC) intends to grant federal-limited or special-purpose bank charters to fintechs. Under the proposals, fintechs will be able to apply to the OCC for a license that supports national standards. Banks are rightly concerned about potential new fintech disruptors that have not had to make the investments in updating risk management processes that banks have made in the past decade. Significantly lowering regulatory standards could have the opposite effect from what banks expect, by accelerating new fintech competitors.

Figure 2: Survey respondents agree that traditional banks will increasingly face competitors from outside the industry.



Value matters more than volume

With customers more willing to try new competitive offerings that let them conduct transactions on their own terms, institutions are challenged to balance the more costly high-touch/high-value products and services against the pressures to generate revenue through high-volume options.

Sustainable customer value, rather than short-term revenue wins, should drive decision-making for banking leaders. This is a fine balance, however, and banks should be careful about implementing new fees that may boost noninterest income in the short term at the expense of nurturing potential lifelong clients.

Banks have to ask themselves an important question: Are they competing solely on cost or on customer service? Successful banks will likely combine both to satisfy fast-evolving customer demand.

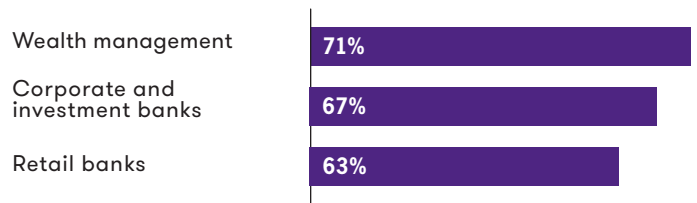
The regulatory pendulum swings, but who wins?

The Trump administration has frequently pointed to the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank) as an example of regulatory overreach. Our research shows that organizations across the banking spectrum believe that they invest so much in defensive regulatory compliance that they cannot focus on innovation and growth (see Figure 3).

Dodd-Frank is an extensive patchwork of complicated regulations, but with it the banking industry and wider economy are more protected. But there is little doubt that Dodd-Frank is under the microscope, and the president and Congress seem to be in harmony when it comes to softening its impact. The bank executives we spoke with are hopeful for regulatory change, but they don't expect the regulators to shift their philosophy in the next six to 12 months.

There are lessons to learn from the reasons for previous regulation. Insisting that banks have enough capital and liquidity to survive any subsequent downturn was important, especially for systemically important financial institutions. Meanwhile, some industry commentators are calling for regulation that requires banks to be good risk managers, with the right technology in place to analyze data and assess real-time risk exposures.¹

Figure 3: Banks are in agreement that too many resources are invested in defensive regulatory compliance.



¹ Euromoney, *Regulation: Trump's Misguided Motives*, March 2017.

Taking steps today to secure the future

Banks need to prioritize key areas to drive growth and provide returns for their customers, shareholders and stakeholders.

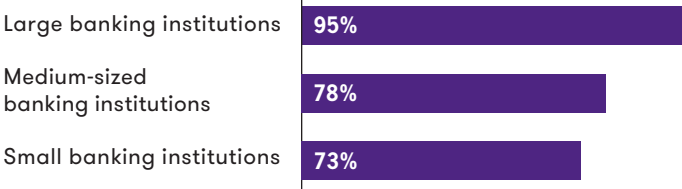
Simplify the business and operating models

Banks need to take the dual approach of simplifying their business model and product range and automating costly or inefficient processes. Over recent years, many banks have grown through acquisition, adding new and duplicated products, channels, systems, processes and costs.

In our research, a large majority of banks say that to remain competitive they must address significant complexity and inefficiencies in their operating models. As Figure 4 shows, this is a particular priority for large banking institutions.² In addition, close to three-quarters of banks (73%) agree they must radically simplify their product portfolio and channels.

Banks need to radically simplify their operating models, starting with the markets and customer segments they serve. Eliminating unnecessary products and features can in itself be a major driver of increased efficiency. Product rationalization creates a multiplier effect through reduction in the associated costs of marketing, training, reporting and other administration.

Figure 4: Banks of all sizes agree that they must address significant complexity and inefficiencies in their operating models to compete in the future and drive out further costs.



Consolidation for efficiency

Will the quest for greater efficiency lead to an increase in M&A in the banking sector? “The overall industry results and market valuations have generally improved in the last three to four quarters,” says Jose Molina, a principal in Grant Thornton’s Financial Services Advisory practice. “But despite the improved performance, consolidating forces are back in the industry and we should expect increased M&A activities — especially in the segment under \$10 billion — as upscaling is driving inorganic growth and efficiency quest.”

² Large banking institutions are defined as those with revenue of over \$1 billion a year; medium with revenue of \$500 million to \$1 billion; and small with revenue between \$250 million and \$499 million.

For most banks with long histories, product complexity is built into their operations. Many will want to evolve to a simpler offering, but they have to balance their sources of profitability. “We will keep multiple products when we see they’re worth keeping,” says Fehlman of Simmons First National Corporation. “However, if you’re a new customer or you’re an existing customer wanting a new service, you don’t want to look down a laundry list of 30 or 40 products.” Instead, he adds, banks should tailor three or four relevant products to customers.

Moving to a rationalized set of operations and IT platforms is a tougher proposition, but is critical to drive out complexity and increase productivity. Given the spider web of existing architectures and interfaces, some banks may need to consider ringfencing existing platforms while building new foundations.

Industry ‘utilities’

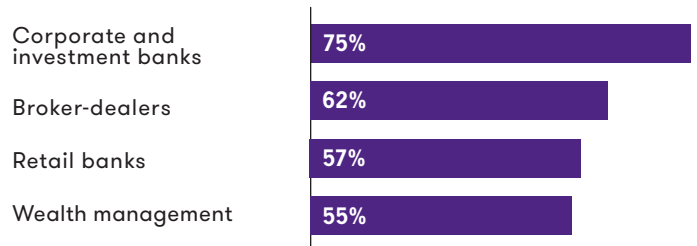
Banks are also establishing cross-industry “utilities” to address core functions that are not a source of competitive advantage for the banks but will help them operate in a fundamentally simpler way. Initial forays have included vital but time-consuming administrative functions, such as know-your-customer rules and third-party risk assessment and monitoring. Banks are looking to extend the model to relieve additional areas of regulatory burden, improve efficiencies and reduce costs.

Understand your customers first

In our survey, an average of 62% of banks describe customer focus as a high priority for the future. It’s hard to imagine how many of the remaining 38% with other priorities will survive.

To deliver on this priority, banks will need to ensure that they know their customers. Analytics can help them draw on information that is often contained in narrow organizational silos. Looking ahead to 2020, banks must make this business-wide view of the customer their top transformation and simplification priority.

Figure 5: Building stronger customer relationships is a high priority.



“Bundling product and services can improve customer satisfaction and loyalty, while providing new revenue streams for financial institutions.”

Nigel Smith, Grant Thornton’s national Financial Services leader

Banks need to identify where they can truly deliver value-added services that will command a market premium. “By taking a customer-segment approach, as opposed to a product approach, banks can identify and understand individual segments, life stages, specific life events and needs that drive opportunities to provide a richer array of value-added services,” says Nigel Smith, Grant Thornton’s national Financial Services leader. “Bundling product and services can improve customer satisfaction and loyalty, while providing new revenue streams for financial institutions.”

Banks and other financial services firms need to reduce complexity in how they interact with their clients. A growing part of this is interacting with their customers via electronic means and using analytics models from these interactions to understand how to drive business performance. “Unless banks achieve these outcomes, they are going to be left with compressing margins and no way to deal with the ways to drive efficiency,” says Frank Hart, president of Greystone Managed Investments.



Top 3 transformation and simplification priorities for banks in 2020

1. Streamline technology platforms so that a single, coordinated profile of the customer exists and is understood across all functions.
2. Automate more transactional services and focus branch staff on higher value-added activities that lead to greater customer satisfaction and loyalty.
3. Know your customers’ needs and assess their channel preferences, including lower-cost digital channels.

Technological advances will create operational efficiencies through improved automation and workforce rationalization. They will give banks a more detailed picture of their customers so that they can tailor their offerings to meet those customers’ exact requirements.

Cloud-based innovations are revolutionizing the banking experience and enabling banks to respond swiftly to customer preferences through cloud-based customer relationship management (CRM) systems. Our research shows that nearly one-half of banks (48%) believe that cloud and software-as-a-service offerings will have a high impact on their business over the next three years.

A lesson from asset managers

“Financial services is still inherently a service business, with human interaction being both one of the most important aspects and one of the highest costs we have,” says Jeff Coons, president at Manning & Napier, an investment management company.

Data analytics can help improve the customer experience. Firms use data to differentiate campaigns and distribute material by channel or client, for example. This improves their customization capabilities and helps to maintain relationships. “All of these elements are easier when you have better CRM capabilities that help firms to target information, content and marketing,” says Coons.

Investment firms often have rich data on customers from across their businesses, but exploiting it will require them to overcome the siloed approach that restricts the flow of data. “Before big-data strategies, investment firms should review the quality of their in-house data, but they need to be able to interpret it,” says Coons. “They also need to be able to organize the data and have adequate resources in place to respond to and make use of it.”

Banks can learn from the experiences of other financial services firms to build customer loyalty.

Manage cyberrisk

Banks' digital-transformation efforts are constantly hampered by the threat of cyberattacks. We identify in our research an alarming finding: Over one-third of banks (35%) say that they do not have the capability and tools in place to mitigate cybercrime. This is an even greater concern for the consumer-facing retail banks and wealth management firms. In our research, 42% of retail banks and 41% of wealth managers say they lack the know-how and tools to fight cyberthreats. These organizations need to build and test a coordinated response plan before a breach occurs, and they need that plan fast.

Quantifying the cost of cyberattacks can never be exact and rarely covers the costs of operational and reputational damage — not to mention harm to customers — but it is a huge and growing problem as evidenced by the massive cyberattack that affected computers worldwide in early May.

As banks expand digital channels, their vulnerabilities from these technologies open up. The move to cloud technology means that banks must understand vulnerabilities of their service providers. In three years' time, 63% of banks say that 50% or more of their IT will be cloud-based. Hence, banks must understand the security of their service providers.

All banks must foster this culture of employee awareness and IT vigilance. Employees should be empowered to understand that if they think a request is suspicious, they can challenge it. The lines of defense need to have joined-up systems and processes in place to identify and defend against threats from within the enterprise.

Hiring the hackers

BB&T, a financial service holding company, announced that it hired hackers with the intent of finding points of entry into its systems. "We have our own intrusion techniques that we use to see if there's any weakness, because terrorists are always coming up with new techniques," said BB&T's CEO Kelly King.³



Getting ready for blockchain

Blockchain revolutionizes the way transactions are handled by eliminating the need for third-party clearing/intermediators or central authority for peer-to-peer transactions. It's widely considered to be as transformational as the internet was. Yet the speed of the blockchain revolution in the market depends on changes in the market structure, regulators' response to the technology and the related risks that emerge.

Larger banks are not waiting. They are building blockchain partnerships and consortiums, developing their own innovation labs and filing patents on their developments. Hundreds of blockchain startups are springing up, unencumbered by the larger banks' legacy technology systems and distribution channels.

The biggest benefit for banks is the immutable, time-stamped nature of the process capturing the transaction, which strengthens the lines of defense and provides greater transparency in assessing where the lines have been weakened.

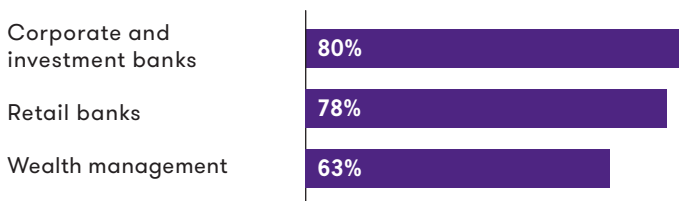
³ Prior, John. "BB&T Hired Hackers to Crack the Bank," *Dallas Business Journal*, April 7, 2017.

Balance risk and opportunity better

More than one-half of banks want to change the strategic conversation around risk, with 57% putting a high priority on balancing risk and opportunity. Banks are operating in a much-improved climate that will help them to focus on opportunities. It's important to note that ignoring business opportunities may be interpreted as a risk in its own right.

In our research, 62% of banks say that the current low-returns environment is the biggest threat to their growth today and will continue to be into the foreseeable future. However, if they advance their digital transformation programs and increase their understanding of customers' needs, they can boost their returns by deploying resources where they will be most effective. Banks need to rebalance their portfolios while still focusing on risk. As Figure 6 shows, this is relevant across the industry, but it is a particularly strong priority for corporate, investment and retail banks.

Figure 6: Institutions agree that in today's low-returns environment they need to rebalance their portfolios to focus on growth while still managing risk.



Banks need to build more strategic risk management capabilities. There is a particular challenge in the pace of compliance. Banks are finding that when their operational "first line of defense" struggles to keep pace with the changes, their risk leaders in the second line of defense need to fill the gap, often at the expense of developing more forward-looking models that can strategically evaluate risk versus reward.

Risk capabilities need to be holistic and sophisticated. Customers and counterparties increasingly want to know in detail whether a bank has a sustainable business model, is properly governed and had any regulatory violations.

Coordinating and integrating the lines of defense

To help ensure institution-wide communications and compliance, banks use the Three Lines of Defense model to clarify essential roles and duties:

1. Management control
2. Risk control and compliance oversight functions
3. Independent assurance

It is not enough that risk and control functions exist; the challenge is to assign specific roles and coordinate effectively and efficiently among these groups so that there are no gaps in controls or unnecessary duplication of coverage. Clear responsibilities must be defined so that each group of risk and control professionals understands the boundaries of its responsibilities and how its positions fit into the organization's overall risk and control structure.



Changing expectations of compliance: The view from a chief compliance officer

As banks look to better balance risk and opportunity, the expectations placed on the compliance function are changing: They are required to focus on critical, defensive activity and opportunities.

A chief compliance officer at a financial services company, which spans online banking to corporate finance, confirmed this dual focus of the compliance function in an interview: “We’ve seen a shift from being perceived as a support function to more of a trusted business partner,” he explains. “We’re being brought in early in the thought process, for example, for a new product or an acquisition. We think through pros and cons with our business partners, considering potential pitfalls, or positive or negative impacts.

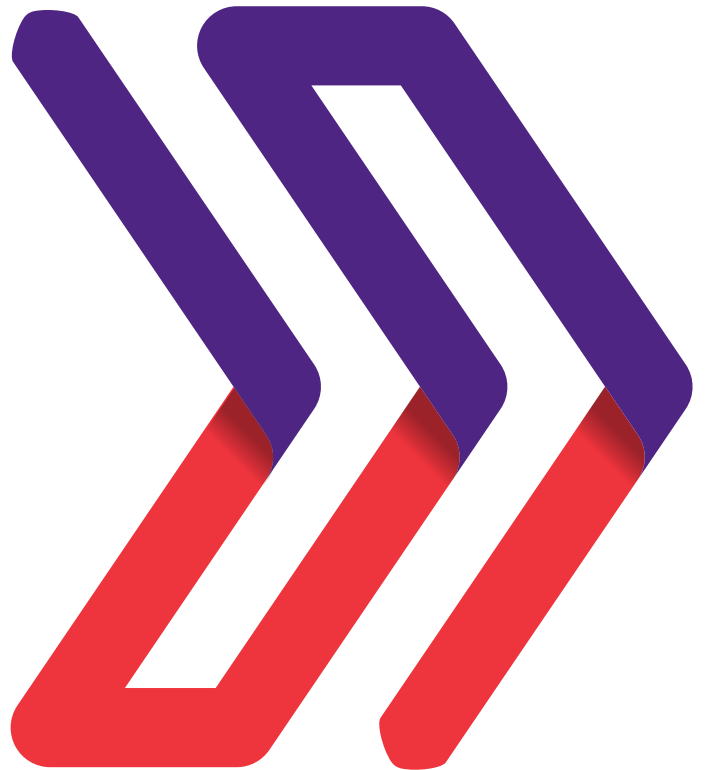
“Of course, sometimes, we have to say no to things if they don’t fit into our risk appetite. But hopefully, if we’re brought in early enough, we can structure the process slightly differently to address any regulatory concerns. We’re not there to say no: We’re there to help our business partners get to a yes, and be able to do it in a compliant manner.”

Conclusion: Evolution or revolution — it's time for change

Banks realize that their business model must change. New competitors, new distribution models and new technologies are redefining customer expectations.

Banks must exploit technology as quickly as possible to help them advance their crucial digital transformation. They are operating in a disrupt-or-be-disrupted era: Swift innovation, automation and operational efficiencies are the order of the day.

Having survived the challenges of recent years, banks must now grow their customer relationships in a manner that drives true economies of scale. That will require finally tackling underlying complexity to offer a better customer experience while driving a simplified operating model. Whether that change is evolutionary or revolutionary will be determined by their competitors and stakeholders, including regulators, shareholders, employees and, most important, customers.



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About the research

We surveyed 357 leaders in the banking industry, seeking to understand key growth and transformation priorities for the future.

Respondents were drawn from CEOs, CFOS, CIOs and managing directors.

The research was conducted by Longitude Research on behalf of Grant Thornton, and the survey was supplemented with in-depth interviews with a range of U.S. business leaders as well as Grant Thornton subject matter professionals.

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