

Top 7 European Financial Services Issues for 2005 and 2006



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May 2005

Reference # V43:14E

TowerGroup Take-Aways

- European financial services institutions are working hard to retain clients and expand the financial resources they manage, and they are counting on traditional customer relationship management (CRM) methodologies to reach these goals.
- Focusing on the client is critical to the growth of universal banking in Europe; outsourcing and business process outsourcing (BPO) provide a welcome release of resources.
- The 1990s was a time for domestic consolidation; the next decade will see cross-border acquisitions throughout Europe with the encouragement of the European Union.
- Channel integration has been elusive in Europe, where competitive pressures have forced most banks to introduce ill-advised enhancement schemes.
- The delay in attaining important business metrics is far too great for an industry that processes client information in real time; much effort will go into filling this gap.
- Regulations are overwhelming the financial services industry in Europe, with no sign of a reprieve, and as a result, the industry will have to learn to use regulation as a competitive advantage.

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Report Coverage

This Research Note highlights the primary factors that will affect the financial services industry in Europe for the period ending 2006. Though interviews with Europe's leading universal banks, TowerGroup has identified the main areas of concern, the areas that additional investment will target, and the projects that will be discontinued through 2006. In addition, TowerGroup has spoken with the leading providers to the European financial services market to get an understanding of research and development targets, sales imperatives, and resource allocations. We have also taken into consideration emerging technologies and developing business models. Lastly, TowerGroup has considered changes in the behavioral patterns of the European financial services client to discern the primary issues that the European universal banks will focus on in the coming two years. This is by no means an exhaustive list of issues; it is just the issues that TowerGroup believes will command the greatest attention from the banks through 2006.

Background

2004 was a year of recovery for European financial services providers. Stabilization of the drastic swings in the economy and a change in the confidence level of both retail and institutional clients in their universal banks characterized the scene: in short, an industry moving back to traditional banking values of relationship building and conservative principles. Advisory services are becoming far more important as clients gain the confidence to get back into the capital markets but are not willing to self-direct their investments.



Also important has been a shift in the power base within European firms, moving from the back office and the principles of cost reduction to the front office and the target of growth. While cost reduction, or more specifically cost rationalization, is still an issue, firms are more likely to spend on revenue-generating initiatives.

Financial services institutions in Europe have a solid history and reputation for innovation and longevity; in fact, countless banks in Europe date back hundreds of years. Monte di Pieta in Siena, for example, was founded in 1472, 20 years before Christopher Columbus made his historic voyage; the New York Stock Exchange started 190 years after the Amsterdam Exchange opened in 1602.

Europe's infrastructure has pushed financial services technology to its limits; multiple languages, currencies, national regulations, and partners have all added layers of complexity to the development of the industry. Yet European banks have retained a global leadership position.

The top 300 banks in Europe (tier-one banks) were able to generate over \$180 billion (USD) in profits last year while building \$1.11 trillion of market capitalization. Europe's financial services giants, such as HSBC, ING, UBS, and BNP Paribas, are among the largest banks in the world. The European Union (representing 25 of 46 European countries and 460 of Europe's 730 million people) is encouraging consolidation as it continues removing cross-border issues and encouraging more European universal banks to join the ranks of the world's biggest banks.

The distribution of financial services providers in Europe is illustrated in Exhibit 1. As the exhibit shows, less than 1% of the top 300 banks are outside the European Union's original 15 countries.

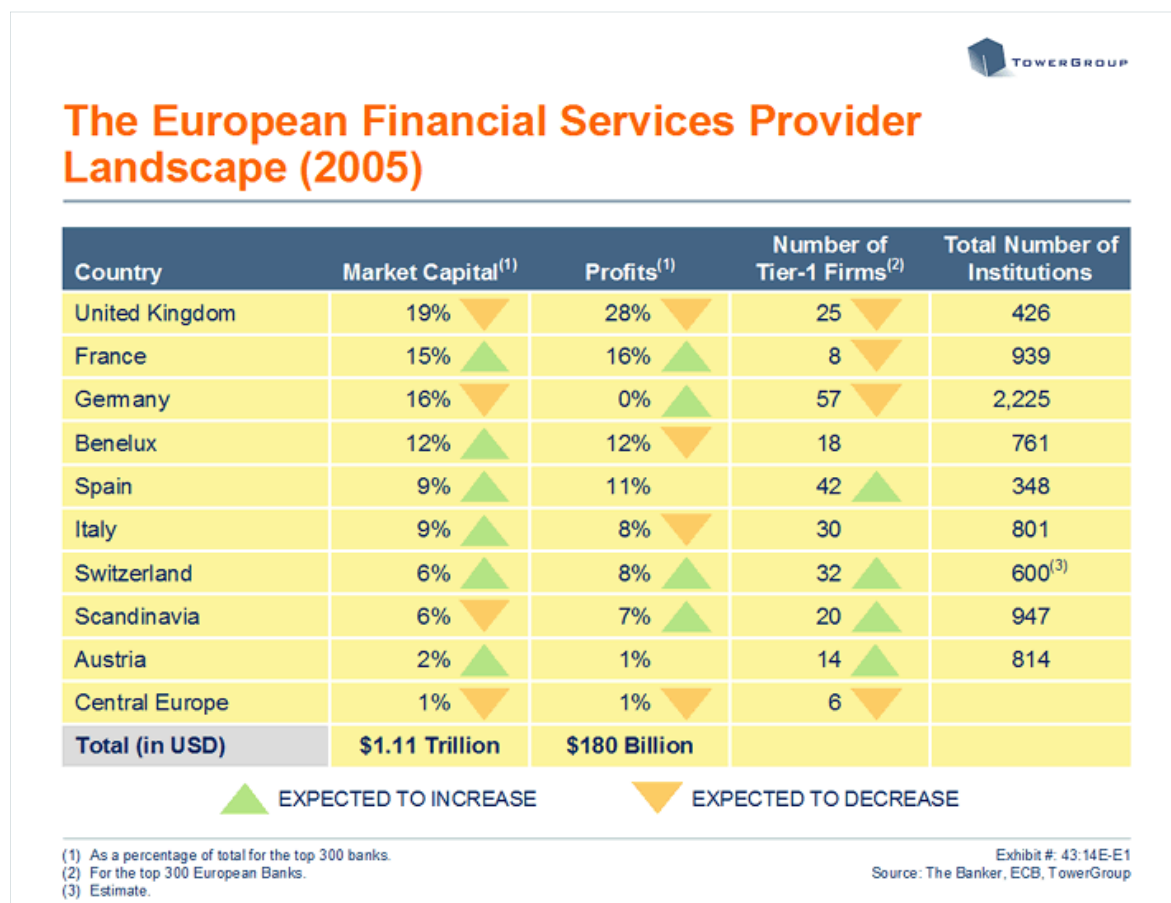


Exhibit 1
 The European Financial Services Provider Landscape (2005)
 Source: The Banker, ECB, TowerGroup



The Top 7 European Financial Services Issues

The European region is vast, the cultures are many, and the regulations are complex, but through the maze that is the European financial services industry are a number of visible threads common to all. Of the hundreds of issues the industry needs to address in the years surrounding the decade's midpoint, the following will attract the most attention and investment:

- Share of wallet
- Focus
- Risk management
- Consolidation
- Channel strategies
- Metrics
- Regulatory concerns

Share of Wallet: The CRM Story

Customer relationship management (CRM) has, by all measures, been a dismal failure in the European financial services arena. In fact, the mere mention of the CRM acronym causes a negative reaction. The European financial services industry has spent upward of EUR4 billion on CRM initiatives without much to show for it. It costs the average European financial services provider about EUR20 million for a five-year rollout of a retail CRM system. This represents considerable investment for a financial services institution, and senior management is struggling to justify the cost. Many believe that the returns will come in the form of economies of scale; therefore, many corporate operations, investment banking, and private banking departments are being asked to take on retail CRM implementations in an effort to find synergies for them.

The problem is twofold: First, only 16% of the costs are actually software costs, with the rest of the costs not subject to economies of scale. Second, and far more important, retail CRM initiatives are not appropriate for serving high-value clients (high-value clients are defined as either individuals who are responsible for their own portfolios or those of a company or individuals who manage large volumes or a high value of transactions). In the coming years, additional high-profile CRM failures are nearly certain to occur.

A number of trends will become apparent during this period. For one, outsourcing of CRM will become commonplace. Already standard in retail bank call centers, outsourcing will begin to impact most channels.

CRM initiatives for high-value clients in Europe will begin to shift away from targeting the needs of the client and to focusing on the needs of the relationship manager who serves those clients. This may seem like a subtle difference, but deployment of a relationship management system requires a radically different approach. These CRM implementations are unique systems designed to increase the efficiency of relationship managers by allowing them to manage more clients or a portfolio of greater value while using the same resource level.

The period will also begin to see solutions to the most significant shortcoming of CRM in Europe, populating the databases. At the decade's midpoint, only a fraction of the necessary information is ever captured, but initiatives are already in place to install compensation plans that would include incentives to employees to populate the databases, greatly increasing the value of CRM implementations.

CRM will also begin to play a greater role in risk management. To date in Europe, CRM systems are stand-alone systems completely separated from complex risk management tools. The result is two or more separate databases if, as is often the case, each channel is managing data separately. The logical next step is to integrate the two to create a risk/CRM function that will afford compliance



with new regulations. We should begin to see this integration in the next two years, starting with the securities and investments industry.

Focus: Outsourcing and BPO

In a recent discussion with a major European tier-one financial service firm, a board member told TowerGroup, "We are spending 75% of our time at every board meeting discussing operations and technology . . ." essentially forgetting about the client. This firm signed a \$1 billion outsourcing deal with the intention of increasing the amount of time and attention spent on its core business.

Several substantial sourcing deals have ended in the past year; notable is the JPMorgan Chase early termination of IBM Corp.'s seven-year \$5 billion contract awarded in 2002. Recent large-scale deals did not have the flexibility needed for a dynamic business such as financial services. Financial services organizations are also responsible for these failures because many of the functions' sources were in a horrific state and inappropriate for sourcing. As many as 25% of the current deals will collapse as a result or face serious modification. At the same time and for the same reasons there will be a steady increase in new, albeit smaller, sourcing deals, both traditional outsourcing and BPO.

TowerGroup estimates that the value of deals will remain steady, with 36% of financial services firms in Europe budgeting between EUR2 million and EUR7.5 million, while another 36% are budgeting well over EUR7.5 million. There will also be two or three more megadeals such as those with ABN AMRO and Deutsche Bank in the next two years. The overall European market by 2008 should be around EUR12.8 billion.

Current large deals (more than \$1 billion) will continue to evolve. In 2004, UBS Investment Bank negotiated a modification of the sourcing deal originally signed in 1996 with Perot Systems. This kind of flexibility on the part of vendors will constitute another important trend as they seek to revive or renew relationships with major financial services clients.

Barclays' outsourcing of application development to Accenture in a six-year EUR740 million deal evinces a more cautious approach, including an 18-month bidding process that involved 12 vendors.

At 5.5% year-over-year growth, European outsourcing is outpacing the 2.9% overall IT spending growth rate in Europe. This rate of growth in outsourcing is expected to continue through 2008. Sourcing has without question become part of standard business practice. However, it has not yet matured into the group management function of European universal banks with all sourcing initiatives still decentralized. Sourcing will move from the control of the line of business to an overall group control within the next two years in Europe and become interwoven with the financial services strategic doctrine.

Financial services has always had a strong preference for sourcing partners with specialized industry experience, but only 30% of outsourcing spend goes to industry specialists. We will begin to see a strong move toward vendors with direct industry experience, and in the next two years, we should see at least 60% of sourcing deals negotiated through industry specialists.

The industry finally has turned the corner and realized the true benefits of sourcing. Last year, the majority of sourcing deals (54%) were put in place to allow the firm to concentrate on core business and not to reduce costs. This is a positive sign and should allow for a greater success rate with vendors as financial firms look beyond cost and toward reliability and flexibility for their selection process.

By the middle of the decade, almost 80% of European banks will have more than 10 external service providers, which is far too many to manage efficiently. The years immediately following will see a consolidation of these relationships, with the tier-one vendors aggressively adding services to provide a holistic solution for banks. Many smaller vendors will disappear, either to acquisition or through unsustainable business models, a scenario especially compelling in Europe, with its countless small in-country vendors.



The principal areas initially targeted for outsourcing in the coming two years will be disaster recovery, security hosting, infrastructure, and application development.

Risk Management: It's All About Operational Risk

Operational risk is the exposure to loss from failures in the operations of a bank in areas such as technology, compliance, and fraud. In the past few years, the European financial services industry has experienced hundreds of incidents averaging about EUR50 million per incident, showing that the importance of operation risk cannot be ignored.

Operational risk management is becoming increasingly important for a number of reasons:

- Basel II has provided guidelines that the industry can use as standards; therefore, any investment in operational risk is protected for the long run.
- Vendors have had sufficient time to develop products that better manage operational risk, providing many viable options for the financial services institutions.
- Consolidation increases operational risk as the number of risk points substantially increases.
- Brands in Europe are heavily penalized for operational faults.
- Market capitalization suffers and shareholders revolt when operational failures occur.

Operation failures have always been measured by the financial costs associated with the technical or fraudulent activity. The problem with this metric is that it represents only a fraction of the actual market capitalization loss for the same period. Financial services institutions are experiencing an average 2% drop in overall market valuation up to 120 days after events that cause at least EUR1 million of financial loss, which represents a 12 times greater loss than the actual "hard" financial loss for the same incident. In the coming years, banks will begin to realize how important operational risk really is and invest more to address the problem.

Exhibit 2 illustrates that immediately after an incident is announced, the market capitalization declines by about 200 basis points, which is a far more than the actual capital loss attributed to client behavior.



The Costs of a Failure in Operations

Basis Points

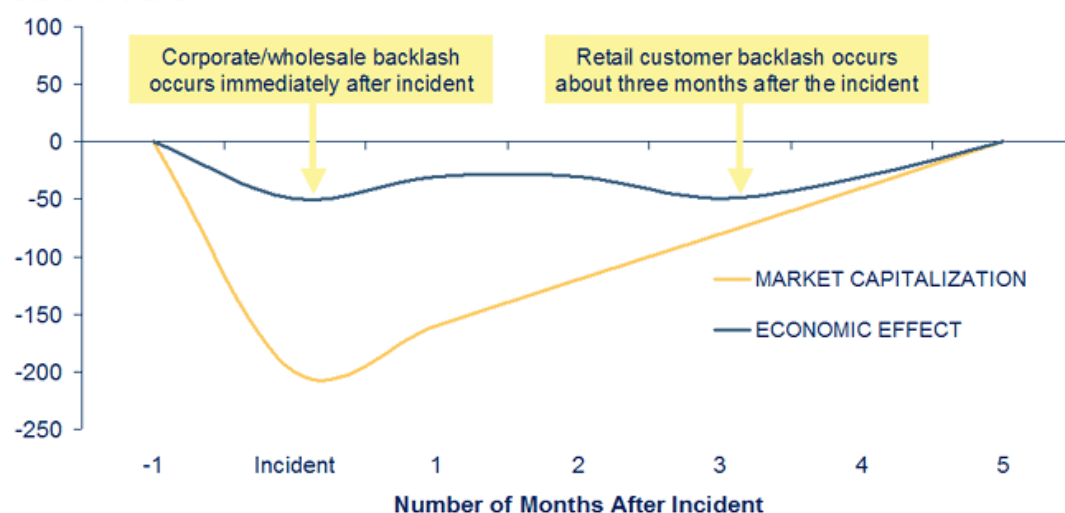


Exhibit #: 43:14E:2
Source: The Banker, ECB, TowerGroup

Exhibit 2

The Costs of a Failure in Operations

Source: The Banker, ECB, TowerGroup

The European market has had a level of protection against operational failures because while initial events are made public, subsequent efforts or investigations are more likely to remain private, in stark contrast to the situation in North America. This focus on privacy has taken operational failures out of the press soon after the incident, and thus the market capitalizations have rebounded much more quickly. This luxury will disappear as publicly accessible reporting comes under increased scrutiny by local regulators and the European Union directives for financial services.

The universal banking concept typical in Europe is also putting operations at greater risk than is the case in the United States. Brands are all linked, and an operational failure in one part of the bank has a direct effect on the rest of operations. In fact, experience has shown a definite process to the incidents: They affect the capital markets business, both retail and institution, so as a result, clients are less likely to send order flow to the institutions immediately after an incident. Three months after the incident is when retail feels the backlash, with customers questioning credibility and considering other parties when making large investment decisions.

Most problems are correctable; in fact, only 34% of the incidents are related to fraud, 8% are process failures, and the rest are due to negligence. Technology has a role to play in this area. Focusing investments on analyzing current operations and systematically removing the areas of highest risk will begin to reduce the opportunity for incidents based on neglect. This is where the vendor community is focusing efforts to provide the market with valuable off-the-shelf solutions to some of the areas of highest risk.



Consolidation: Merger Activity Continues

While domestic merger activity in the European Union's original 15 countries is expected to continue for the next few years, the opportunity for substantial growth in the category has greatly diminished since the late 1990s. The new generation of mergers is primarily defensive posturing. Most multinationals went through mergers during the 1990s, so the majority of domestic merger opportunities lie with tier-two and tier-three operations.

During the 1990s, the rationale for mergers was obvious: extraordinary efficiency gaps between the acquiring firm and the acquired. Today, cost-effective technology solutions have removed most of those gaps, resulting in a less attractive market for acquisitions. In the coming two years, the primary rationale for domestic merger activity will be the acquisition of needed skills, not economies of scale and not efficiency gains.

The regulatory environment, specifically the European Union directives on financial services, will simplify the process of cross-border mergers. It is likely, however, that most firms will be unwilling to wait for the implementation of the directives before pursuing cross-border acquisitions. Spain's Santander was one of the first to exploit the cross-border opportunity when it took over Abbey National of the United Kingdom. Today, ABN AMRO is looking to take over a bank in Spain, and Spanish banks are casting an eye over Italy. This is the beginning of a trend that will dominate the European market for the next five years. Unfortunately, the realized benefits will not be as dramatic as those from domestic consolidation; in addition, diverse technologies as well entrenched corporate cultures and strict labor laws will ensure less-than-expected returns.

The European market will continue to see consolidation in the east. TowerGroup expects the growth rate in Eastern Europe until at least 2010 to be 19% year over year, enticing every major financial services provider into the market. However, corporate, wholesale, and investment banking dominate the market to the tune of 64%, compared with 45% in Western Europe. TowerGroup expects this rate to normalize by 2010 at about 50% for Eastern Europe. This shift seems to indicate that the market opportunities are predominantly in retail, but universal banks will continue to do well in the market. Currently, UniCredito, HVB, Erste, and KBC have all entered the markets through significant acquisitions. Technology is less of an issue in these acquisitions because most eastern European firms either have very poor technology that the acquirer replaces with modern systems from the west or have already invested in new technology in the years after the breakup of the Soviet Union. One word of caution: Debt levels will grow faster than assets as Eastern European firms strive to attain Western lifestyles, which means debt instruments will come before investment products.

The United States is a big target for European banks, especially the universal banks such as the Royal Bank of Scotland, whose American holdings include Charter One, Citizens Bank, Peoples Bank, and HSBC, which purchased Household International. Now that Citigroup has at least temporarily ruled out large acquisitions and JPMorgan Chase and Bank of America are still digesting their own recent large-scale mergers, the European banks have an opening that they will exploit. Unlike in Europe where acquisitions are followed by implementations of consolidated systems, the US market will continue to operate independently from European parents because the US regulatory environment makes it difficult to consolidate systems.

China will also be a target for the large European banks. Recent deals such as ING's acquisition of Bank of Beijing will become more common. The challenges are great. The first is that the Chinese government has set limits of foreign ownership in many of its most promising banks, leaving less than 20% of banks available to individual foreign banks, well below controlling positions. Technology issues are also significant because the systems currently in place are radically dissimilar. Although the Chinese banks are modernizing rapidly, it is often the case that Western technologies are inappropriate. There should be separate operations in this territory, at least for the next few years.



Channel Strategies

Over the past 15 years, ATMs have been able to reduce human-to-human transaction by almost 15%, making a good argument for new channels to be added to the mix. However, over the same period, overall transaction levels have doubled as customers have gained easier access to accounts. The result is that the total cost for serving each client has in fact increased. Channels are a double-edged sword, and while technical channels do reduce individual transaction cost, they also affect clients' behaviors in ways that may not be anticipated.

The European market is struggling. Although most banks have added channels as a result of technical capabilities, competitive pressures, cost-reduction exercises, or marketing programs, none has introduced channels based on customer preference. Today, four out of five Europeans still prefer to bank in person and a mere 8% are using online services.

This customer preference for person-to-person interaction has been poorly reflected in the overall strategic direction of the universal banks in Europe, but signs of change are emerging. Eighty-four percent of European financial service institutions are in the process of renewing branch networks or are planning to renew these networks, which form the most important channel to the European retail customer. The goal for all banks should be simple: Figure out how your clients want to interact and build a channel strategy around that. As rudimentary as that sounds, it is not common practice in Europe. Although European consumers are very keen on new technology and it doesn't take much convincing to get them to try a new channel, they stop using the channel unless they have clear benefits. Nevertheless, 70% of European financial services institutions anticipate increasing channel capacity (both the number of channels and the volume per channel) in the next two years. On the other hand, only 2% of European financial services providers indicate they want to reduce capacity.

The coming two years will also see a focus on metrics for channels. Today, few banks understand the effects of individual channels on the overall channel mix or the total costs of each channel.

CRM and channels will become more tightly integrated in the next few years. While individual channels rarely were implemented without CRM capabilities, these capabilities were equally rarely integrated into an enterprise CRM plan, thus creating numerous unrelated databases. Today, most banks are asking how individual channels can integrate into their expensive CRM implementations, forcing vendors to open architectures so that databases can be shared.

Determining customers' needs is the key success factor in channel integration. With traditional human contact, the need of the client is ascertained early in the conversation and the interaction is managed accordingly. In self-directed channels, the need of the client is not known. Technical self-directed channels will evolve around the individual needs of clients and the channels will evolve not only to complete transactions but also to advise on the best type of transaction to fulfill the needs of clients.

European banks have realized that channels are not products, devices are not channels, and most important, channels are never the foundation of a relationship. These are important revelations because European banking customers have a preference for universal banking firms, and channels are merely supporting the brand. In the coming two years, European banks will practice brand integration to ensure that the brand principles are adhered to, regardless of channel. This integration should cause some firms to remove channels that are contrary to brand values, mostly in the private banking market where brands are based on personal contact above all else.

A relatively new trend in Europe will be the outsourcing of channels. Although call centers have been outsourced for some time, ATMs, Internet infrastructures, mobile banking, and payment systems are being outsourced to specialists. This practice is in line with strategic sourcing plans that will allow only core competencies to remain in-house.

Vendors will evolve in the next two years as they begin to focus on channel harmonization and integration. Instead of selling individual, proprietary systems, they will begin to sell solutions based



on open systems. In addition, vendors will increase the number of hosted solutions, providing banks with viable application service provider (ASP) models.

The challenge for European financial services providers for the next several years is clearly to balance technology channels with human interaction. Those that find the right mix will dominate the market, and those that don't will begin to see client retention levels dwindle.

Metrics: Business Intelligence

The average financial services institution in Europe takes about two months to compile and analyze the data needed to report quarterly statistics to the marketplace. In an era of real-time processing and 24-hour markets, this time lag has caused some small, easily addressed problems to become major issues in many financial services operations. For this reason, we will begin to see an increased investment in the management of business intelligence throughout the European financial services industry in the coming two years.

Real-time access to business metrics is a key industry target for the next several years, and TowerGroup predicts that by the end of 2006, the industry will have access to 27% of its data in real time as compared with 10% in 2002. More dramatic will be the increase in the amount of data that will be accessible within a week: from 15% in 2002 to over 25% by the end of 2006. However impressive those results are, they are mostly due to improvements in front-office systems that have vastly improved database management capabilities. The upcoming two years, however, will focus on addressing the data that takes over a week to compile.

Data collection difficulties generally start with the complexity of systems in place today. Both internal and external communications are using many channels and many dissimilar systems, forming a maze of regulatory compliance that differs from business unit to business unit and that includes complex financial and enterprise resource planning (ERP) systems, CRM and customer-facing systems catering to individual products, and proprietary business unit systems. All conspire against the consolidation of business information.

To cope, banks are centralizing the data-gathering function and assigning responsibility to a senior-level group manager. Today, about 30% of firms have a central governance professional who oversees the collection of business intelligence for the firm as a whole. In the next few years, the number of firms with such a responsibility will increase to near 85%.

Internal control methodologies are becoming more widely used in the industry, where financial services firms adopt very elaborate controls such as Control Objectives for Information and Related Technologies (CobiT), Systems Auditability and Control (SAC), Committee of Sponsoring Organizations of the Treadway Commission (COSO), and Statement of Auditing Standards (SASs 55/78). The methodologies are very strict, and although they were designed initially for very specialized industries, many banks now have adopted them for various appropriate departments.

Data quality has been a challenge in Europe. The banks in Europe are old and have elaborate legacy systems whose primary input methodology is the relationship manager. Banks need to account for not only "fat finger" errors (in typing) but also selective or fraudulent inputs by relationship managers trying to retain power through control of information. The result is an upsurge in the number of vendors developing tools in this area, and the current 12% year-over-year increase in solutions targeting this space should continue through 2006.

Enterprise portals for information exchange have become very popular in Europe. Seen as a part of a data-gathering methodology, they should provide a good foundation to a business intelligence plan in the future. Unfortunately, too much time and effort are being spent on development of methodologies instead of the far more important common understanding of the data. Financial services operations are labor-intensive operations, and generally speaking, those who come across data seen as important will use any available method to make sure it gets to the appropriate eyes. It is important to begin to educate employees on how to recognize valuable data and then provide them with a system to move that data.



Care must also be taken in assigning metrics to an individual. When an individual is assigned a metric, managers begin to run their operations to improve the metrics instead of running the business. Because most metrics are poorly selected, trying to attain a particular metric can, and often does, run contrary to overall company goals.

IT departments will begin to embrace and lead business intelligence initiatives over the next two years. Fully 65% of European banks believe strongly that business intelligence improves the value they can extract from their IT investments. While such a conclusion is seemingly little more than common sense, in an era of IT rationalization, anything that improves the visibility of IT will be welcome.

An area of concern for European financial services institutions is the enormous shortage of professionals with the appropriate skills to manage a business intelligence initiative. TowerGroup estimates that the demand in the next two years will exceed the availability of professionals by at least two to one. For this reason, TowerGroup expects to see some failures in business intelligence implementations because of the compromise in skills that will have to be made.

European firms are increasingly focused on their business intelligence projects that serve a particular need. Over 70% of projects are attempting to deal with profitability analysis and a slightly lower 65% of projects are addressing CRM analytics. In contrast, their US counterparts are targeting 60% and 30%, respectively. This difference results primarily because of the complexities of the universal banking model as well as the rather late start of European institutions into the business intelligence space.

Accomplishing the task of accessing all the necessary data is, of course, not enough. Once that concern has been addressed, the next step is to take advantage of the information. TowerGroup estimates that the average European financial services provider today has about 75 terabytes of data in the information areas necessary for reporting. Only 67% of that data is being processed analytically, and only 33% of the data processed analytically is affecting strategic decision making. Exhibit 3 illustrates how much work remains; a mere 17% of the overall data is considered during the strategy development stage. Firms need to spend the next couple of years getting more leverage out of the data they already have. This challenge will begin to get more attention in the coming years but will likely not be addressed in the short term.



Uses of Available Data by European Financial Services Institutes (2005)

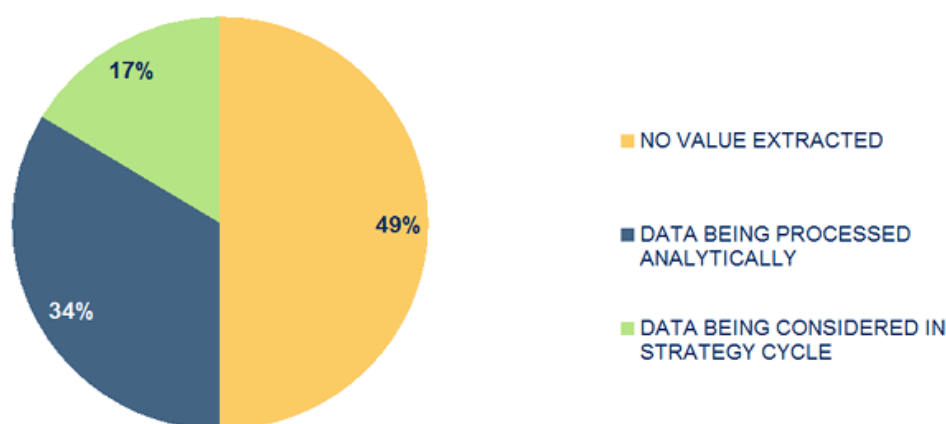


Exhibit # 43:14E-E3
Source: ECB, TowerGroup

Exhibit 3

Uses of Available Data by European Financial Services Institutes (2005)

Source: ECB, TowerGroup

Regulatory Concerns

The financial services industry has always been subject to a myriad of regulations spanning numerous agencies, both domestic and international. Although regulations are difficult to manage on their own, financial services organizations are being asked to consider more regulatory changes in a single small window than we have ever seen. The only period that even comes close is the time immediately after the Great Depression of the 1930s.

Regulatory bodies in Europe are complex and numerous. There are hundreds of regulatory agencies and regulators in Europe, including central banks, finance ministries, ministries of trade and commerce, insurance regulators, banking regulators, securities regulators, and exchanges, and many other nonbinding regulations are imposed by the industry. It is a veritable minefield with no shortcuts. While the European Union is working hard at harmonizing the rules throughout the union, it is an insurmountable task that will be unfinished as long as cultures in the region remain distinct.

In addition to local regulations, a dozen regulations cover operations globally. They include European Commissions Capital Adequacy Directive (CAD3), International Association of Insurance Supervisors (IAIS), Solvency 2, Insurance Industry Modernization and Consumer Protection Act, Sarbanes-Oxley Act, California Senate Bill 1386, International Accounting Standards Board (IASB), Basel II, FAS 133 and 150 (Financial Accounting Standards), European Commission Privacy Law, International Accounting Standards (IAS), and Data Standards.



National issues are also of concern to universal banks that operate in several geographies. They include such regulations as the Companies Bill in the United Kingdom, the German Cromme Code, the Austrian Osterreichische CG Kodex, Italy's CG Code, Switzerland's Swiss Code of Best Practice, Spain's Aldama Report, Portugal's Recommendations of CG, France's CG of Listed Companies (AFEP/MEDEF), Belgium's Directors Charter, and the Dutch Tabaksblat Committee.

Financial services organizations are struggling to keep up, and most are approaching the situation with the wrong mentality. When asked how they see regulatory oversight, almost all senior managers refer to it as a burden, an unwanted infringement on their business. At the same time, when asked if regulations help keep business free of renegades, all senior managers say that they do. They also agree that some regulation is necessary to manage the perception of the industry, which is extremely important for an industry based on trust.

It is regrettable that the new regulations are being seen as a burden, because they are in fact an opportunity. Providers of financial services are suffering from a loss of credibility in the eyes of the public, which assigns blame for the poor economy, the dot-com bust, and the extension of credit beyond what is reasonable. New regulations are being put in place to protect consumers from these perception problems, which is very good for the industry as a whole. The beauty is that the regulations affect everyone, so everyone has to spend some money to comply, and those that spend it wisely will come out ahead in the end.

Also associated with all these new regulations is the risk of a false sense of security. Many firms are working incredibly hard at compliance in the belief that doing so will put them in a completely secure position. The reality is that banks must remain flexible, prepare for unforeseen events, and above all take responsibility for their actions. This means that it is not enough to change the technology or the operational methods. Rather, financial services providers must change the culture within their firms, develop flexibility to recognize risk factors, and mitigate problems before they occur.

The costs for compliance with regulations are also on the rise. HSBC, one of Europe's largest financial services providers, indicated recently that in 2004, it spent over \$500 million on compliance with regulations, which represented a 25% increase over the year before. In fact, over 20% of tier-one banks in Europe spend over 15% of overall costs or more on compliance, and that number is expected to grow over the next few years.

The costs of being out of compliance are very high. While most firms can deal with the majority of compliance fines, they have trouble with the cost to the reputation of their brands. European banks have mostly consolidated universal banking brands built on traditional brand principles, resulting in a situation of noncompliance that has a large and detrimental effect on a brand.

Summary

The financial services industry in Europe is looking forward, beyond its history and its legacy systems, to address the needs of a more integrated and complex continent. Clients are key; retaining clients and increasing share of wallet will become the goals of every financial services institution on the continent. Technology will play a role, but so too will the development of corporate cultures that strive for a good understanding of the client.

European banks evolved on a foundation of personal relationships. Over the years, technology has stepped in to destroy the delicate balance that existed. Financial services providers will concentrate on their core business, the business of relationships. Banks will seek out partners to take on the operational burdens so that they can concentrate on the needs of the client.

Operations may be sourced externally, or they may be developed in-house; in either case, firms need to understand the risk that systems pose to their business. Operational risk management is a difficult concept to understand for most, but understanding it is necessary for security.



There is a chronic oversupply of financial services products in Europe, which is a problem that will be remedied over the next few years through the continued consolidation of the industry. Along with an integrated channel strategy, banks will expand beyond their domestic borders to create integrated, multichannel European and global banks.

Businesses of all kinds need to understand what is happening behind their own doors, European financial services institutions are struggling to accumulate data and distribute it to the appropriate people. In the coming few years, advancements in business intelligence will allow for more precise strategic planning.

Europe has a bright future in financial services. Banks will become more global, far larger, and better run if they just manage their investments and concentrate on the client.