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Stanwell

1 ARE USUAL CLIENT METRICS ENOUGH TO REFOCUS EUROPEAN CIB CLIENT PORTFOLIOS?

While US CIB institutions have been gaining market shares for the last couple of years, European institutions are still struggling to achieve their operational performance programs.

In fact, Tier-1 US CIBs accounted for more than 50% of the overall CIB market in H1 2019, with Cost-to-Income ratios far lower than those of their international counterparts (i.e. 55% vs. 63% in H1 2019).

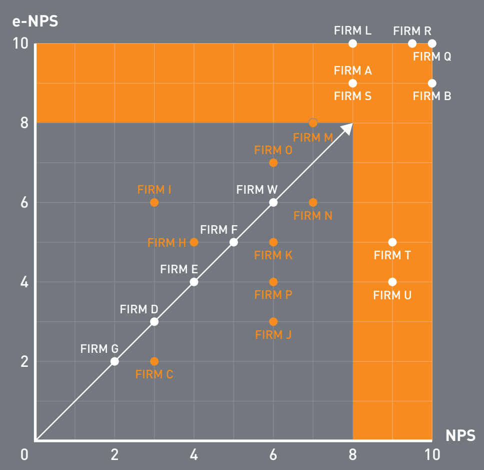
In this context, we believe it is key for EU players to address customer knowledge, in order to tackle both bottom and top lines, and start shifting from a pure cost play to a more mixed approach. Besides, implementing such initiatives should not create significant incremental investment costs, while optimizing the cost, revenue and risk equation of CIBs.

Enhanced customer knowledge is basically built around three key elements:

1 • Client data – Quantitative and qualitative data gathered through multiple touchpoints with clients and / or from alternative data sources. From our CIB experience, client data is often incomplete and / or of poor quality (e.g. timeliness, group structure).

2 • Client analytics – Customer metrics enabling optimal structuring of client portfolio to enhance client sales and retention and streamline operations. At many CIB institutions, usual metrics do not fully capture value creation (e.g. cost components) and emotional stickiness of clients (e.g. NPS vs. e-NPS alignment).

3 • Client infrastructure (i.e. processing & monitoring tools) – Execution and monitoring of related processes. In CIB, a couple of disruptive levers can be used to optimize infrastructure. New Dataviz opportunities may indeed enhance recurring portfolio screening and reallocation. Machine Learning may also improve existing data cleansing processes.



Aligning NPS and e-NPS is critical for firms that intend to grow their promoter base

» Few companies can achieve or sustain high customer loyalty without a cadre of loyal, engaged employees.

» Aligning customer net promoter score (i.e. NPS) and employee net promoter score (i.e. e-NPS) is a pre-requisite to accelerate a company's trajectory to grow its promoters' base.

» Employee Net Promoter Scores can be substantially lower than customer scores, as employees often hold their firm to higher standards than do clients.

1 ARE USUAL CLIENT METRICS ENOUGH TO REFOCUS EUROPEAN CIB CLIENT PORTFOLIOS?

Implementing an effective customer knowledge enhancement program can prove to be quite difficult. Whilst some firms struggled in the execution of these programs, others have refrained from initiating them altogether, due to infrastructural factors, or simply the lack of right talent. Simultaneously, sales leaders can have trouble prioritizing such initiatives when faced with important clients.

Companies that have been successful in implementing enhanced customer knowledge projects have taken three specific steps to overcome the most significant common obstacles:

- Thrive for customer knowledge excellence: Leaders recognize that perfect data does not exist, but by choosing their battles and using innovative tools (e.g. machine learning for data cleansing, dataviz for client portfolio screening and reallocation), they are able to extract valuable insights even from incomplete existing data, and thus, justify greater efforts and investments in data overtime.
- Analytics based culture: It is vital to promote / attract IT and analytics talents, but those that have enshrined an analytics culture into the core values of their company have proven to be most successful. Organizational setups that are sales driven, customer centric and foster overlaps between digital and coverage units do have a significant competitive advantage.
- Support from C-level: Based on our experience, there can be a significant mismatch between what certain management teams believe to be the metrics used in their firms and the reality on the ground. Thus, C-level managers need a better grasp of their firm's starting point, the importance of customer analytics, and get involved in associated initiatives.

Impacting both top and bottom lines, well-designed customer knowledge roadmap should also include change management through training, communication, incentives and performance management to fully onboard coverage units and deliver on promises. It is obviously critical to align the firm's ambition in terms of analytics and salespeople to execute the related initiatives and then capitalize on what they have to offer. In fact, there are plenty of benefits enhancing customer knowledge, apart from purely assessing salespeople or calculating traditional metrics such as revenue per client, namely:

- Client selection: enabling the tiering of clients via advanced quantitative and / qualitative metrics for future cleansing / promotion / efforts.
- Service adjustment: adapting post trade service levels based on specific hard and / or soft metrics
- People matching: optimizing coverage planning, field productivity and people management (i.e. better matching of people to deals).
- Lead generation: using analytics to score and generate sales leads.
- Customer lifetime value: maximizing value through cross-sell / up-sell and churn reduction.
- Pricing: leveraging tiered / dynamic pricing for individual or bundled solutions / services.

Having said that, **we definitely believe that EU CIBs should assess their positions vis-à-vis their best in class peers through detailed benchmarking analyses and transparency, and take the necessary steps to pull this "low hanging fruit" lever and quickly optimize their revenue, cost and risk dimensions in a challenging competitive landscape.**

2 IS "SHRINK TO GROW" THE ULTIMATE SILVER LINING FOR EUROPEAN BANKS?

The aftermaths of the global financial crisis have spurred waves of stimulus to help the global economy recover.

Central Banks have played their part, especially within the Euro zone where ECB's main refinancing rate has been 0 since March 2016 and the institution said that its key interest rates would remain at their present or lower levels at least through H1 2020. We suspect that given the need for Governments in Europe to refinance at low levels to cope with pensions (among other factors), the low interest rate environment should stay lower for much longer. This monetary tool was ironically directed towards banks, but the spiraling effects of negative interest rates have rather compromised banks earnings power by threatening the ability to generate consistent interest margins. The negative impact of negative interest rates has been an ink-shedding, well documented topic, ranging from lower earnings power to distorting credit risk but also failing to kick start inflation and consumer spending (Japanese effect of an aging population enticed to save even in a low interest rate environment). However, looking at figures, it shows that while ROA (net earnings/ total assets) have not returned to pre-crisis levels, they have increased since 2008 in advanced economies overall.

This is explained by the fact that banks have been using several mitigants to fight back a prolonged negative interest rates environment. This includes (but is not limited to): revaluation of longer-term assets, issuing more loans, issuing riskier loans, increasing fee-based business, and above all, reducing expenses. Banks in advanced economies have used traditional techniques, with short-term effects on both the cost base and share price (e.g. staff reduction further depressing staff morale and rewarding shareholders). From January to August 2019, 50k job cuts have been announced by banks globally, among which 44k by European banks alone.

2 IS "SHRINK TO GROW" THE ULTIMATE SILVER LINING FOR EUROPEAN BANKS?

The risks associated to an extended era of low interest rates calls for a thorough investigation of alternative ways to address ROA, bearing the fact that cost reduction evidently appears less viable in the future. We believe that banks ought not to only address their operating model by cost reduction but also their business model and strive for the rise of a new industrial model. Specifically, the adoption of disruptive technologies combined with a consistent digital strategy can help extract further efficiency gains while exploring new business opportunities. We identify four categories where Banks should position themselves. Each category represents an industrial model and is empowered by a unique combination of business and operating models.

- Category Leader: High-volume positioning driven by product leadership.
- Niche Killer: High-margin positioning driven by premium product leadership.
- Mass Premium: High-volume positioning driven by numerous client relationships.
- Tailor-made: High-margin positioning driven by premium client relationships.

Ultimately, we believe that banks cannot be subscale in any of their businesses and should refocus on their core capabilities. **Hence, we believe that banks should contemplate a "shrink to grow" move i.e. focusing on key core business, discard non-core activities and build on their strength to become a leader in their categories while optimizing their operating model simultaneously.**

3 IS CREDIT RISK PRICING BECOMING AN AI DRIVEN ACTIVITY?

We believe that as new technologies such as Artificial Intelligence kick in, credit risk pricing will be revisited and in turn, become a source of competitive advantage.

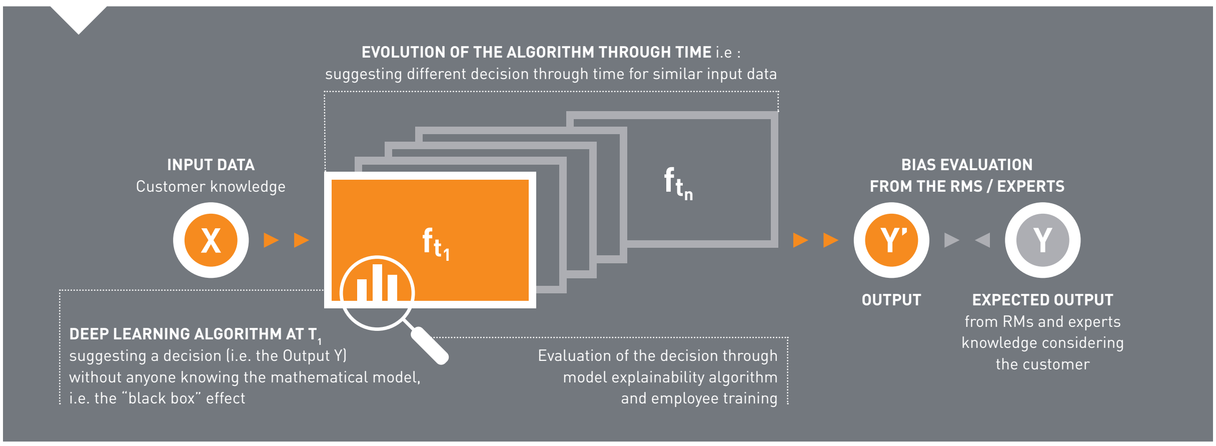
European Banks are bound to navigate through a significantly long period of near zero / negative rates. Given the limited revenue elasticity of many retail and corporate segments, many banks are in search of further cost improvement levers and enhanced management of scarce resources.

We can foresee several "hard" and "soft" attributes of AI aided credit risk pricing, for instance:

- **Attribute #1:** Ability to piggyback on new data sources to capture additional data such as a) Central Bank data for Corporate credit history in wake of DSP2, b) Digital platform (e.g. Amazon) or micro payment actors (e.g. Apple Pay) to help massify "near default" data.
- **Attribute #2:** Ability to price credit in real time across a wide range of instruments.
- **Attribute #3:** Ability to help decipher "default" behaviors from emotional factors (e.g. anxiety) when a borrower "chooses" on which line he could default.

A number of FinTechs / eBanks have started to use AI for enhanced credit pricing (e.g. WeBank for Retail, RiverBank-Bolden for Corporates). While "digital at scale" remains rather distant for a number of actors, we believe the fight for "credit granular data" is on. We anticipate partnerships between banks and "data providers" in different forms to happen (cf. Goldman Sachs – Marcus in 2016 and Apple alliance with Barclays up to august 2019 then with Goldman Sachs for the launch of the Apple card). Even more so, many global CIBs are noticeably investing a lot to make room for themselves in "Retail" credit.

With this paradigm shift of technologies enhancement, the need of understanding how AI algorithms are making decisions - even though they might perform well - will increase. In fact, this will be as much an ethical as a practical issue for most financial institutions – how could a professional recommend a financial product or take a decision based solely on an AI algorithm with limited to no knowledge of the decision-making process?



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Interestingly, this is far from being a specific banking need: we believe that most services industries will face the same challenges (e.g: the health French governmental agency - "Haute Autorité de Santé" – recommended to pass new laws and norms on this specific kind of challenges that we detail below[1]). But despite the growing reach of AI across industries, the awareness around IA issues and challenges is still timid, and concrete corporate actions rather scarce.

We see four main challenges to be addressed by financial institutions:

- The "black box" effect, i.e. the inability to explain the decision-making process and the implied client segmentation.
- The bias issues which include how minorities / specific cases are (often poorly) handled by AI algorithms.
- Two more technical challenges but with strong impact on core financial activities:
  » The difficulty and cost to develop an effective model depending on the use case.
  » The need to monitor the models in production and make them evolve on a regular basis.

From our perspective, two complimentary types of mitigation exist:

- "Hard" mitigation solutions – i.e. technical solutions
  » One of the most promising solutions in that regard would be the "model explainability" technologies. Those algorithms aim to explain the decision-making process and therefore greatly mitigate the "black box" effect but also offer improvement in the ability to better grasp the AI algorithm bias.
  » We started seeing very interesting results in recent years with several kinds of "model explainability" algorithms (Partial Dependencies Plot (PDP), Local Models (LIME) focus, Shapley value – the most promising so far) but this technology is still to be deployed by any major institution on a global level.
- "Soft" mitigation solutions – e.g. RMs and banking experts training, building new competencies
  » The use of such an algorithm demands that the RMs and experts bypass the algorithm when needed (e.g. specific case with an absurd result). This requires a high-level algorithm understanding by RMs and banking experts.
  » AI algorithms have the particularity to evolve on a regular basis when new data comes in as it is basically an inductive model. This could be disturbing for untrained financial professionals as a specific input could suddenly lead - in extreme cases - to completely opposite predictions and recommendations.
  » Trained professional facing the clients and a well-prepared legal department will become key as new legal issues will arise.

Few banks created their "in-house" cognitive factory (cf. Crédit Mutuel, Orange Bank, Crédit Agricole CIB) to work on those specific issues and the related mitigation solutions.

All things considered, banks should adopt an "AI driven business model" mindset. We believe that the copernican effect on the business and operational side will offer many new business and operational efficiency opportunities in the foreseeable future.

1: Sources: https://etatsgenerauxdelabioethique.fr/media/default/0001/01/e171349ffa32b44e1652eaa130dc4db586066fb5.pdf - Page 5,6 and 7

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