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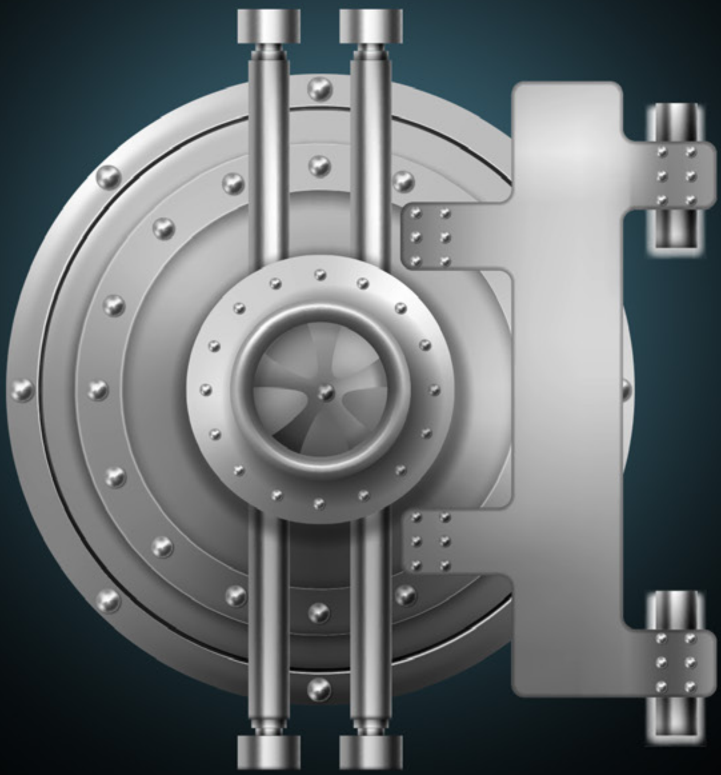
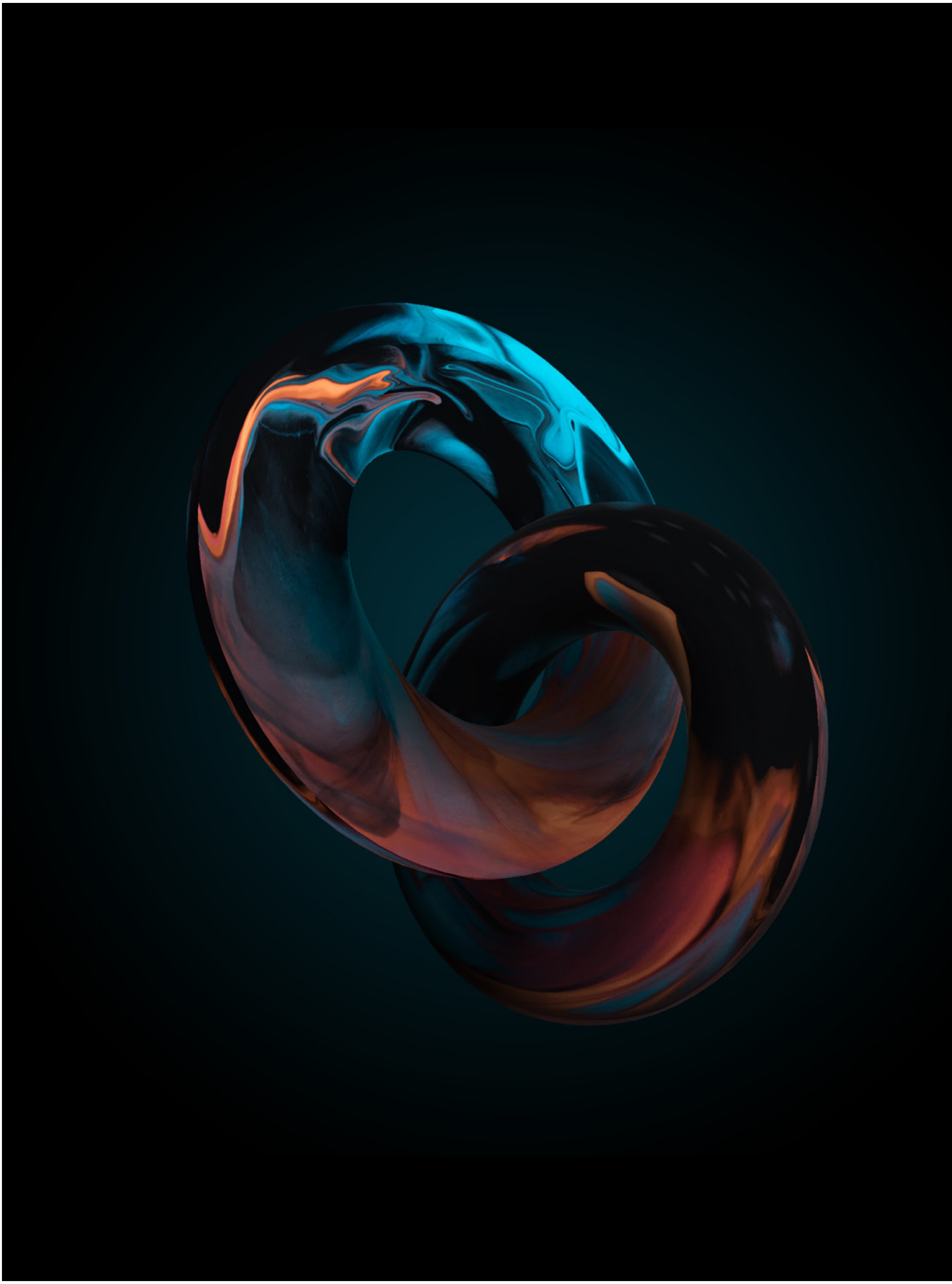
Future Forces 2023:

The megatrends shaping the banking industry



Outpacing change

Based on research by ECONOMIST IMPACT



Key takeaways

Leading factors impacting banks

Ambitions on environment, social and governance (ESG) and net zero schemes, talent and skills gaps, and rapid technology change are the top three factors that will exert a heavy impact on banking operations in the decade ahead.

Talent the top challenge

Securing the necessary talent and skills is the number one challenge that banks will face over the next ten years, selected by almost half of industry executives (42%).

AI a key change driver

The emergence of artificial intelligence is raising the technology stakes for banks. Opportunities exist to boost efficiency and improve customer experience through hyper-personalisation, the top market development (38%) likely to have the biggest impact on banking businesses. But banks must modernise their existing IT processes and infrastructure to tap into these.

ESG will have the second biggest impact

Meeting more exacting ESG standards—demanded by regulators and clients—will have the second biggest impact on banking businesses (37%), after the hyper-personalisation of services. The net zero transition also offers attractive investment opportunities, for example in renewable energy and energy transition projects.

For all the changes that digitalisation has brought to the banking sector in recent years, market structure has shifted relatively little, with incumbent financial institutions remaining dominant.

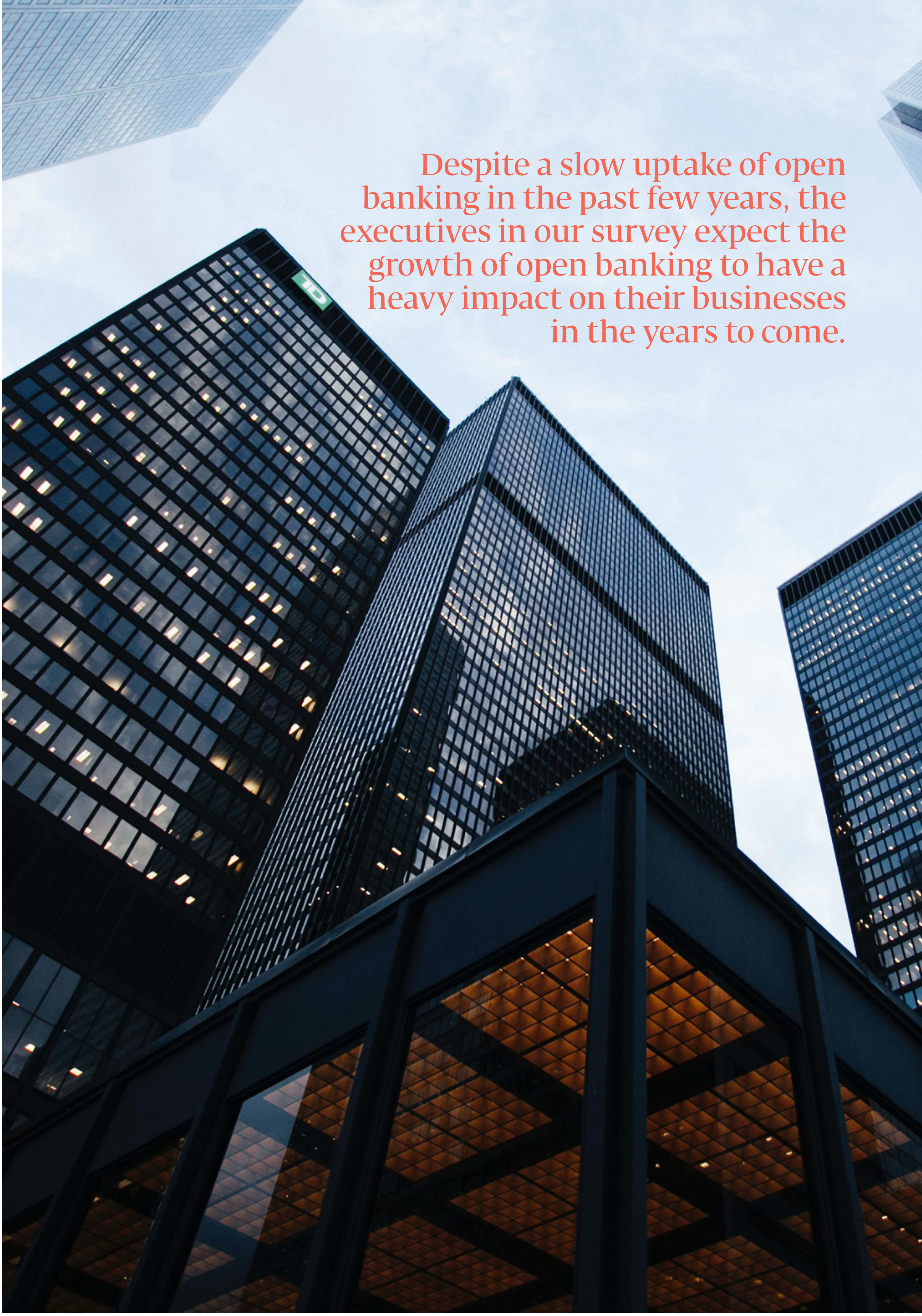
That could change in the coming years, however, as fintechs and, potentially, big technology companies develop the capabilities to reach diverse consumer and business banking segments. Continuing regulatory support of open banking[1] practices will accelerate the growth of such competition.

Despite a slow uptake of open banking in the past few years, the executives in our survey expect the growth of open banking to have a heavy impact on their businesses in the years to come. Likewise, they also expect a large impact from their adoption of environmental, social and governance (ESG) policies. While such developments pose a compliance challenge to banks (the respondents are keeping a particularly close watch on potential new environmental regulations), they also present opportunities. For example, fintechs may compete with established banks in certain segments, but they also provide digital expertise and capabilities that larger players can tap into. And, as we discuss below, banks have much to gain from their investments in the net zero transition.

This article focuses on the banking industry and draws on the results of Economist Impact's survey of 60 global banking and private capital executives.

In the flagship report of this programme, *Future Forces 2023 Report: The megatrends shaping business over the next decade*[2] we explored the opportunities and challenges that six megatrends pose to businesses in the decade to come, presented in the table below. This article presents the key insights provided by executives from the banking sector.

Megatrend	Implications for business
Changing global dynamics	Organisations must develop their risk management capabilities and build resilience to adapt to the growing frequency of political, macroeconomic, public health and other shocks
Net zero transition	Organisations will need to decarbonise their operations and mitigate their climate risk
Digitalisation	Businesses will fall behind if they fail to derive greater value, efficiency and convenience from technological innovation and the digitalisation of their products and services
Demographic change	Remaining competitive requires businesses to adapt their products and services to meet the needs of diverse groups of customers while accommodating workforce ageing and the younger generations' changing preferences
Skills for the future	Amid workforce ageing and continued shortfalls of critical skills, organisations will need to prioritise reskilling and upskilling to fill their gaps
Resilient cities	When cities become denser, more congested and increasingly affected by climate change, organisations can help them remain productive and able to cater to the community's diverse needs



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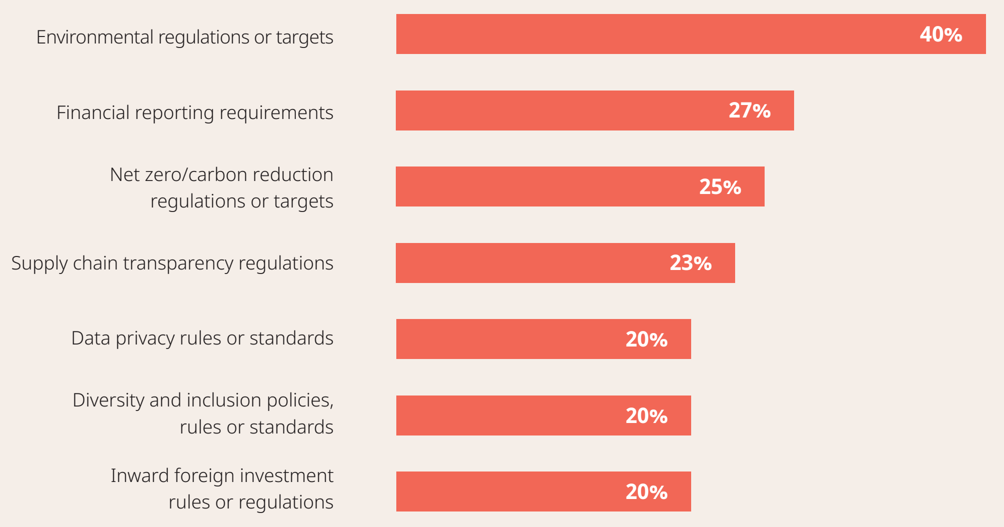
Regulation and the push toward net zero emissions

Climate change poses a range of different challenges to the banking industry, among which compliance requirements loom large for the surveyed executives. Asked which regulatory developments are likely to exert an impact on their business in the next decade, 40% of banking respondents point to environmental regulations. Many (37%) also cite ESG policies (see Figure 2). However, regulatory practices differ widely between regions and there is a lack of consensus on methodologies and frameworks for incorporating ESG into business models in the sector.[3]

Figure 1: The burden (and opportunity) of transitioning to net zero

Potential new policy or regulatory developments that are most likely to impact banking and private capital businesses over the next decade



Source: Economist Impact survey

The demand for greater environmental and social awareness in the sector is not driven solely by regulation. A 2023 McKinsey study showed strong interest from US consumers in green financial offerings, with many willing to pay more for climate-linked products.[4] "More and more banks face customer and client demands for green funds, and investors increasingly consider ESG in their decisions," says Barbara Casu, Professor of Banking and Finance at City, University of London's Bayes Business School.

Potential negative impacts on profitability and a lack of clear, co-ordinated approach towards ESG policies have been weighing on some products, however.[5] According to Bloomberg, the global sustainable debt market saw its first decline in green bonds, (a year-on-year drop of 19% in 2022), after years of strong growth, as a result of high borrowing costs and rising ESG scepticism amongst investors.[6] In the US, anti-ESG sentiment coupled with rising interest rates resulted in a pullback of US$ 5.2 billion from sustainable funds in the first quarter of 2023, making it the third consecutive quarter of fund outflows.[7]

While environmental mandates could increase banks' compliance burden, worldwide efforts to transition to net zero carbon emissions also represent a big opportunity for banks, according to Professor Casu. "Banks are critical to the net zero transition and they have already been at the forefront of investing in renewable energy and other decarbonisation-related projects," she says. Banking executives see another opportunity arising from such activities: exhibiting industry leadership in tackling climate change. In a new partnership, Danske Bank and Realkredit Danmark plan to expand their offerings and ramp up ESG efforts in the property sector by developing common standards and gauging what ESG regulations could mean for finance standards used in the sector. Efforts like these will have the added benefit of improving their sustainability credentials among prospective hires as well as customers.

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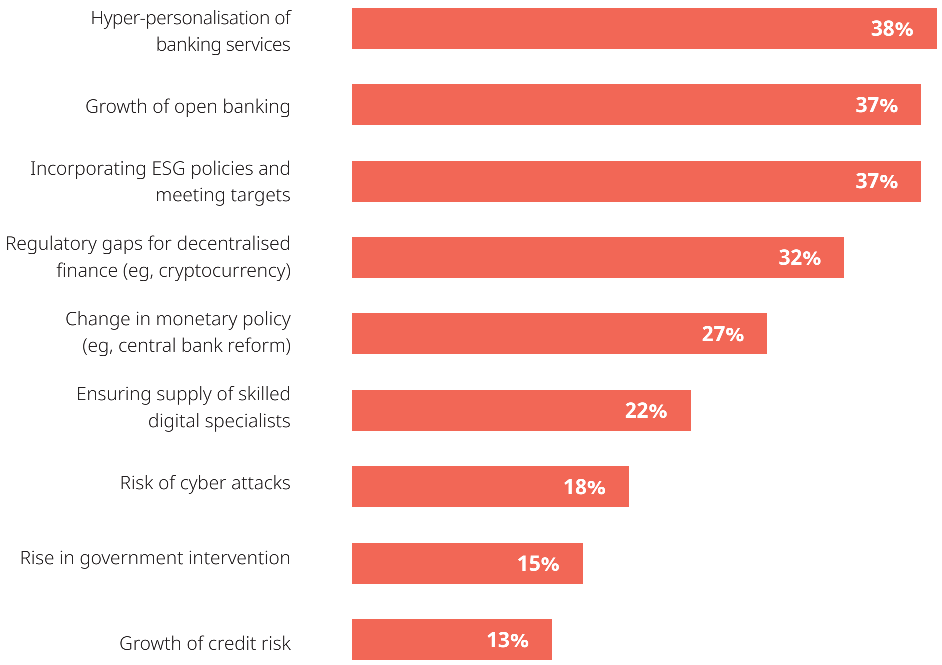
The digitalisation imperative

When asked which technologies could most positively impact their business, most banking and private capital respondents point to automation (33%) and cybersecurity (33%) as being among their top three. Many central banks and financial supervisors, particularly in emerging markets, lack cybersecurity regulations despite their high vulnerability to cyber threats, according to the International Monetary Fund.[8]

Technologies such as artificial intelligence (AI) and advanced data analytics are also giving banks the ability to tailor their products and services to increasingly diverse market segments, including ageing customers and other demographic groups with unique needs (38%). "Banks were among the earliest adopters of AI and are in a good position to expand its uses in their operations as new commercial applications emerge," says Professor Casu. Banks are increasingly investing in generative AI with the aim of refining user experience personalisation, customer segmentation and sentiment analysis, among other use cases.[9] For instance, the Commonwealth Bank of Australia has deployed generative AI to support its staff in evaluating thousands of documents to answer customers' questions in real time.[10]

Figure 2: The personalisation opportunity

Share of banking and private capital industry respondents citing the market developments likely to have the biggest impact on their business over the next decade



Source: Economist Impact survey

The growth of open banking, also cited frequently by respondents as likely to impact their businesses, should facilitate AI-enhanced personalisation. Despite open banking's slow take off, partly owing to concerns surrounding consumer protection,[11] many of the regulations that ensure third parties' access to banks' customer data are in place today in several countries and are likely to come into force soon in the US. This shift should create a better user experience and a more competitive environment for the retail and corporate sectors alike.[12]

Open banking is a particular boon to fintechs and technology giants such as Apple, which may enjoy the upper hand when it comes to personalisation, says Ms Casu. "As big tech companies launch consumer banking services, their technology capabilities combined with the voluminous customer data they already hold could make them formidable competitors to banks." However, going beyond digital payments and offering services akin to traditional banks would mean that tech companies have to adhere to more stringent regulations, including around data usage.[13]

In 2022, Diem, a Meta-backed cryptocurrency, wound down after it could not garner regulatory support due to its complicated structure and governance.[14]

The respondents in the survey also acknowledge the difficulties their organisations encounter in leveraging new technologies to their fullest. Redesigning existing work processes to derive value from new technologies poses considerable difficulties for banks, as does the challenge of replacing legacy IT systems.

Securing talent and skills

Meeting the above challenges will require the talent and skills that many banks struggle to secure. Concerns about such difficulties are common in most industries today, but banking and private capital executives express particularly strong worries in our survey. For instance, 42%, far more than any other industry, say it is the toughest challenge their institutions face in the years ahead.

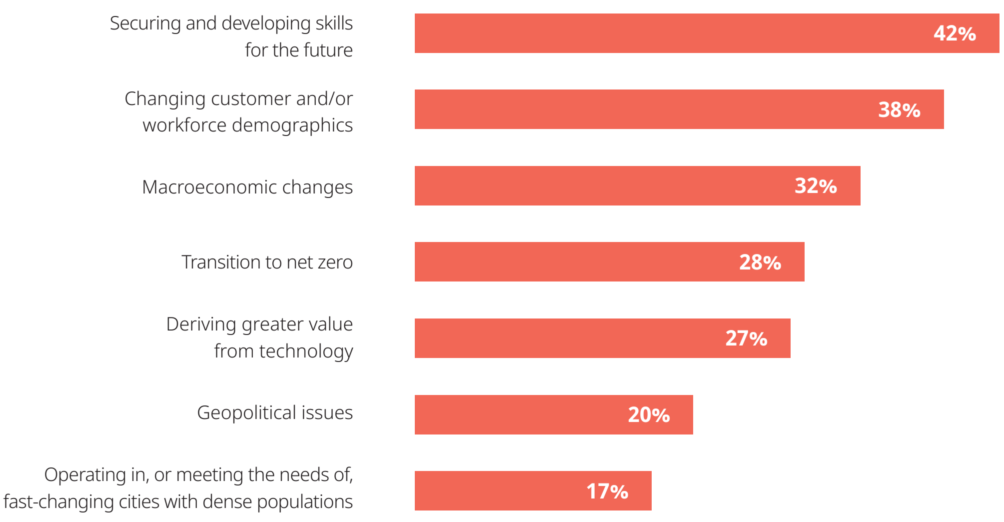
"Banks are rightly anxious about this," says Professor Casu. "They've lost much of their shine as employers since the financial crisis, and young financial talent today tend to gravitate toward fintechs." Rapid digitalisation and technology adoption means that banks are increasingly having to compete with other sectors to secure digital skills.

In our flagship report,[15] experts discussed the need for employers to "think outside the box" as they strive to attract and retain talent in the future. The banking respondents agree, acknowledging, for example, the need to be more accommodating to demands from new hires and existing talent for work contract flexibility.

More broadly, many respondents recognise the need for banks to modernise their talent management strategy and practices, including how they reskill existing employees. This will be imperative to develop a culture of innovation amongst employees and leaders. "With talent pipelines constricted, banks will need to retain more older employees," says Professor Casu. "More proactive reskilling and upskilling schemes for this cohort will be imperative."

Figure 3: Difficulties securing needed skills are unlikely to ease

The megatrends that will pose the toughest challenges to banks and private capital businesses over the next decade



Source: Economist Impact survey

Looking ahead

Energy transition and environmental regulations will continue to significantly impact the banking sector in the coming decade.

While the sector must navigate the uncertainty around ESG regulations and sentiments, the net zero transition will also present many investment opportunities.

Technology advances and digitalisation will continue to impact banks of all sizes, even becoming an existential topic for some. Moreover, large incumbent banks and their digital challengers are increasingly competing for control of customer relationships. Both groups seek to achieve this by, among other things, developing technology capabilities to provide highly personalised products and services to a diverse range of customer segments.

Some of those capabilities will be conferred by AI. However, while banks have already made ample use of AI in several parts of their operations, questions remain about the ability of larger players to make the internal changes that would leverage such technologies, including generative AI, to the fullest. It will be key for banks to understand the business need for generative AI and provide clear use cases to drive the necessary targeted investments.

In particular, mastering such capabilities requires skills that not all banks can be certain of securing. The ability to do so, and to retain them, will do much to determine which players emerge as influential in different parts of the banking value chains of the future.

Partner Perspective

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Institutions are facing an inflection point in the evolution of the banking industry, driven by a number of megatrends.

Retail banking developments driven by technological change are evident to all, many corporate banking changes however, are likely to only become more apparent within the next 12 to 18 months. As an advisor to the world's largest financial institutions, we are fortunate enough to be working alongside them in dealing with these issues.

Investor considerations are being matched by other factors including the increasing focus on ESG compliance, the 'fight for talent' and evolving workforce, and the emergence of generative AI and the fundamental changes it brings to all our preconceptions and certainties of processes, controls and norms.

ESG still remains the number one boardroom megatrend for banks. The differences in approach in different countries and regions are the biggest challenge right now and for the immediate future. Banks must build effective strategies to cater for their firm's global ESG objectives.

The genie is well and truly out of the bottle though when it comes to the adoption of AI in financial services. Both regulators and legislators, globally, will be playing catch up for some time to come. The banks that can successfully implement AI technology will benefit from a large competitive advantage in terms of time and cost savings.

Never have bank senior executives needed such a wide array of skills and abilities to deal with these fundamental issues–and never have they had to operate in a market so influenced by governments and regulators. Already one of the most regulated sectors globally, where will the eyes of the regulators shift next?

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Endnotes

[1] Open banking allows third-party providers to access the financial information of banking customers. It aims to provide customers with more tailored and innovative products and services, and foster more competition in the banking industry.

[2] See Future Forces 2023 Report: The megatrends shaping business over the next decade

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[8] Danske Bank, "Danske Bank and Realkredit Danmark ramp up ESG efforts in property sector", August 24, 2023, https://danskebank.com/news-and-insights/news-archive/news/2023/24082023

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[15] CNN, "Facebook's dream of creating its own global cryptocurrency officially comes to an end", February 1st 2022, https://edition.cnn.com/2022/02/01/tech/facebook-diem-association-dissolving/index.html

[16] See Future Forces 2023 Report: The megatrends shaping business over the next decade

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