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**DATAMONITOR**

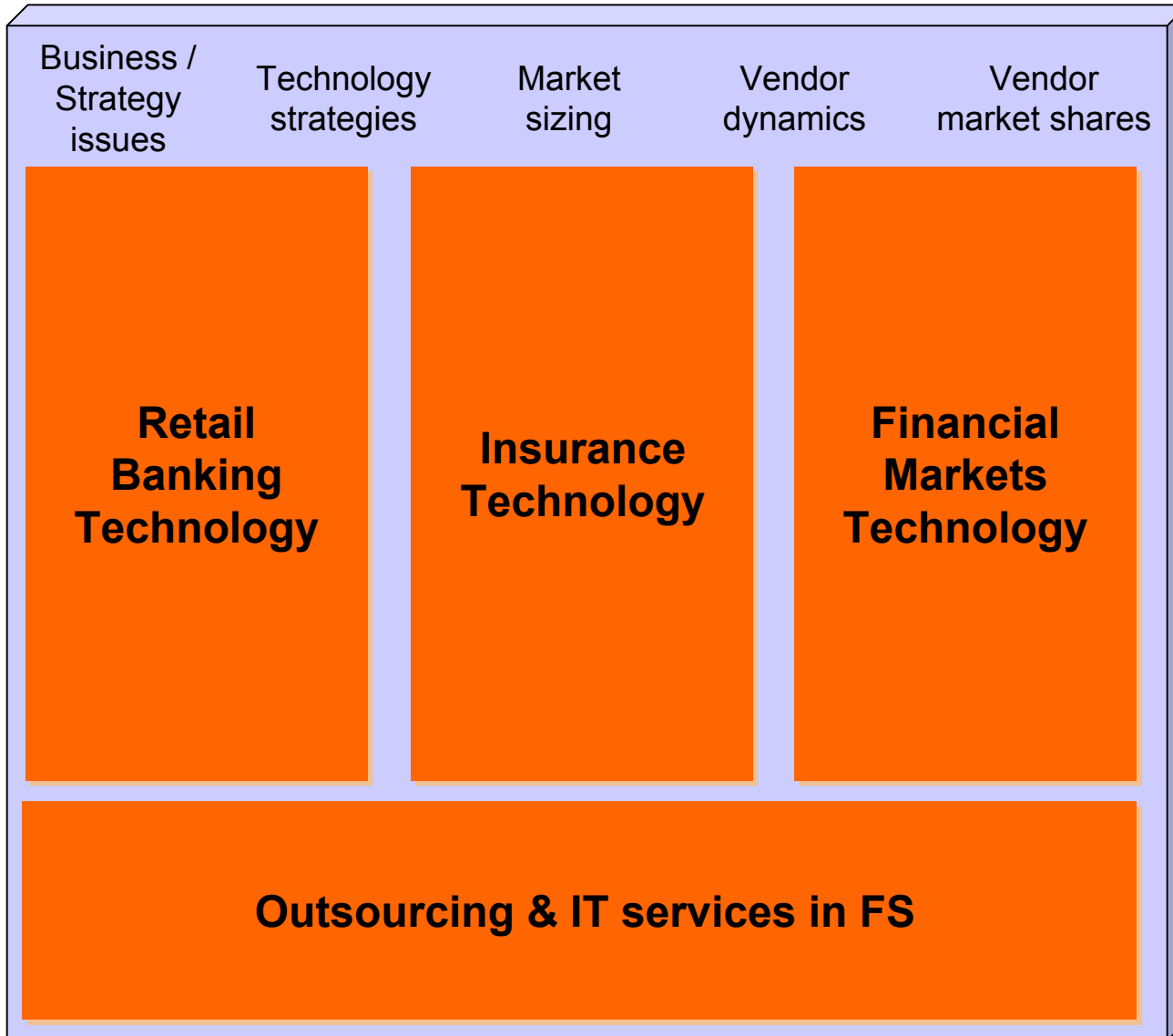
# **Assessing the current drivers for core system transformation**

The right time to replace?

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Lead Analyst - Financial Services Technology

- **Datamonitor**
- Core systems application spending
- Asia Pac / CEE / LA core banking trends
- European core banking trends
- Opportunities for Temenos



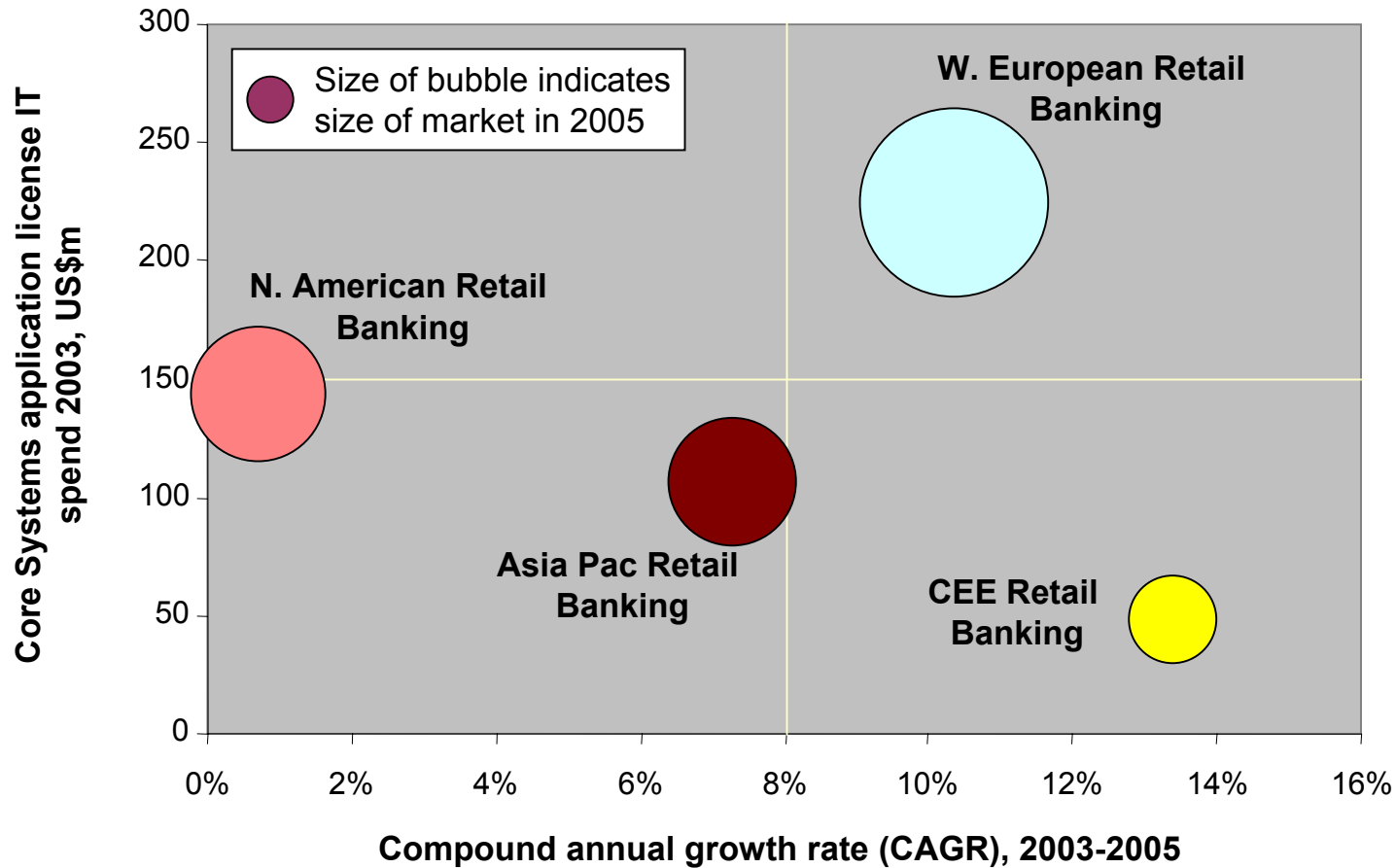
## *Positioning*

Datamonitor's FST SPPs enable banks / IT vendors to understand:

- Business / strategy drivers in the financial services lines of business, at a country-specific level
- The impact of business trends on IT strategies and IT spending trends, with resulting implications for vendor go-to-market strategies
- Vendor selection criteria and the competitive landscape in the key areas of financial services solution spending

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Asia / Pacific market already in top gear, while big-ticket growth in Europe set to accelerate



## Retail core banking application license IT spend, 2003-2005

	2003	2004	2005	CAGR
Asia Pacific	106	118	122	7.3%
Western Europe	225	247	274	10.4%
Central & Eastern Europe	49	55	63	13.4%
North America	143	143	145	0.7%
Total	523	563	604	7.5%

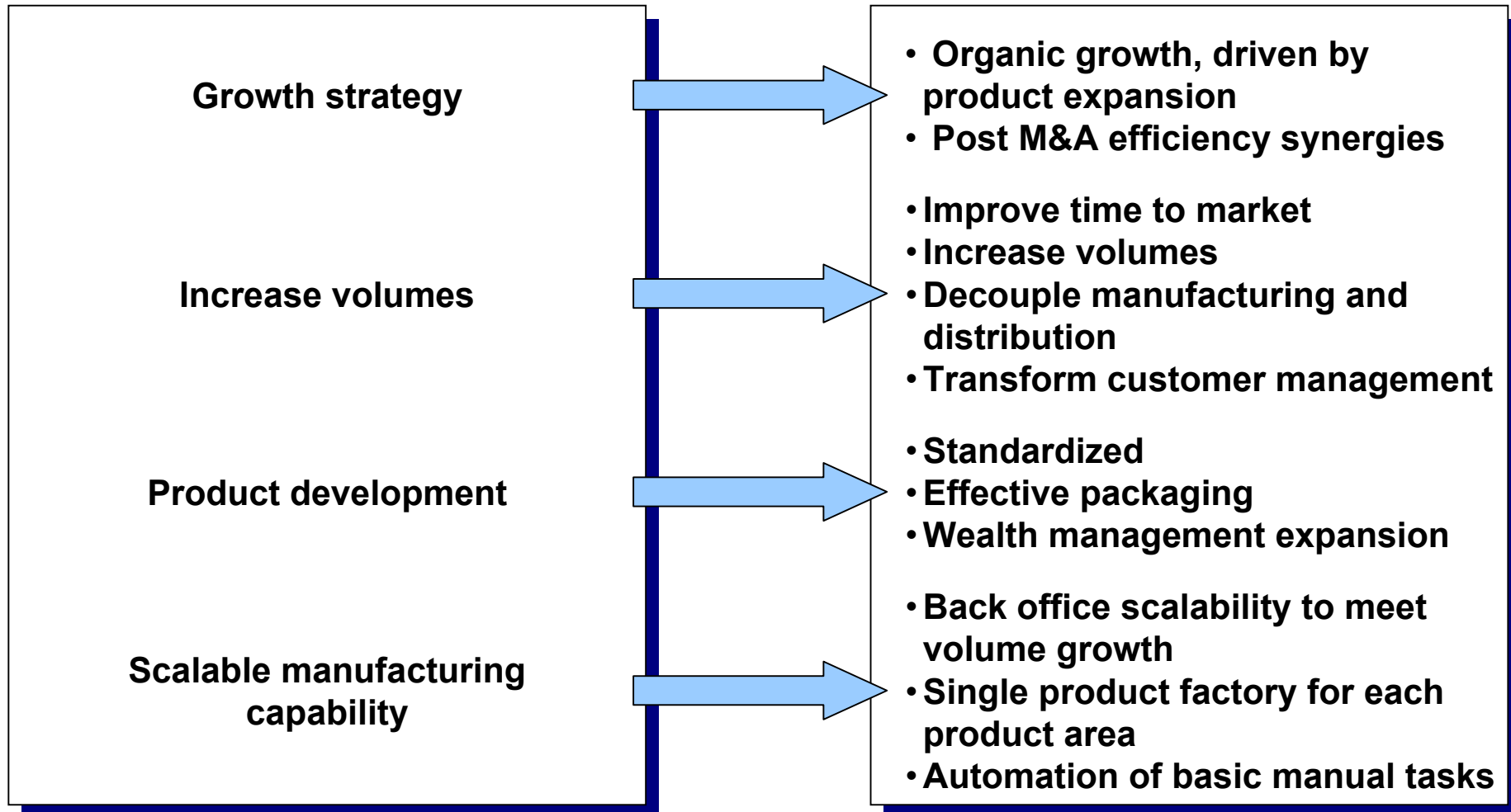
- W. Europe
  - Small number of big ticket Tier 1 / 2 replacement projects
- Central & Eastern Europe
  - Recent hiatus, but cross-border standardization / new markets set to drive renewed growth
- North America
  - Minimal replacement activity as outsourcing pushes up into Tier 2s
- Asia Pacific
  - Significant replacement activity as incumbent local players embark on transformation
- Latin America
  - Local banks under pressure to transform in face of major standardization investments by foreign players

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- Significant core banking transformation drivers in all three regions
- Ongoing replacement activity over recent years means that packaged applications are already well established
- Incumbent Tier 1 banks have been slower to transform, but are now pursuing significantly more aggressive strategies
- Foreign banks with operations in multiple countries aggressively driving cross-border standardization
- More limited product coverage drives requirement for more integrated solution - buildout of best-of-breed line-of-business specific core processing applications only just beginning
- Almost all future replacement activity will be package-based – no ‘glass ceiling’
- Vendor market ultra-competitive

## Market driver

## Strategic implication



- Incumbents waking up need for transformation as foreign banks turn up the pressure
- Product expansion will drive growth
  - Solid growth in core account products
  - Stellar growth in mortgages / consumer lending, mutual funds, life & pensions, wealth management
  - Accelerate fee income growth as interest income growth tails off
  - greater flexibility and time to market in product development prerequisite
- Key challenge is to achieve volume growth while avoiding silo mentality
  - Clear delineation between distribution and manufacturing
  - Efficient business processes
  - Single customer view
- Impact of M&A activity creates need for back office integration

- Western European parent banks are driving transformation of AP / CEE / LA banks
  - Transferring core competencies to build top tier position
- Expansion of product offering
  - Complete portfolio of banking and investment products
- Processes
  - Rationalization of operations headcount
  - Move to shared services
- Focus now moving to cross-border standardization
  - Strategy, Products, Processes, Technology
- E.g - SCH in Latin America
  - Standard core banking application for the Latin American market
  - Centralized datacenter and development for Latin America

- Implementation of new core processing technology
  - Typically packaged systems – ‘buy-a-new-bank’
  - Less complex legacy barriers
  - Relatively low level of technological and organizational maturity
- Product expansion will drive core processing development
  - New product engines for e.g. mortgages / credit cards
  - Deeper line of business functionality
- Going forward, evolving ‘what-you-have’ will increase in importance
  - Standardizing core processing applications / components across country subsidiaries, business units
  - Componentization / Service-oriented architectures
- IT architecture strategy will increase in importance in Tier 1s
  - Decouple front-ends from back office systems
  - Process integration / STP
  - Standardize product-agnostic business functionality
  - Future-proofed integration of new product engines / sales channels / acquisitions

- Asia / Pacific
  - Significant legacy issues for incumbents driving replacement activity in larger markets e.g. Korea, China, India
  - Strong activity in less developed markets - Taiwan, Thailand, Malaysia, Indonesia, Philippines, Vietnam
  - All replacement activity will be packaged...
  - ...But question mark over incumbent banks' ability to execute transformation
  - Japan – market opening up, but internal development predominates
- CEE
  - Most banks in 1st wave EU entrant countries have recently replaced core processing technology for accounts
  - Limited business case for further replacement activity
  - Replacement activity accelerating in Russia / Ukraine and second wave EU entrants
  - Cross-border standardization will drive next wave of investment
- Latin America
  - Larger banks currently more cautious in replacement strategy
  - But competitive situation likely to force their hand, e.g. Brazil, Mexico

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- Retail banking accounts systems are the pinnacle of core systems transformation
- Packaged applications in Tier 3 and Tier 4 European banks well established
- Line-of-business specific core processing modules e.g. loans, well established in Tier 1/2 banks in many European markets
- Growing trend towards accounts core system replacement activity in Tier 2 banks (up to \$50bn in assets)
- Very small number of major replacement projects in Tier 1 banks
- Replacement projects are putting pressure on the 'glass ceiling' for packaged applications
- But majority of all Tier 1 and Tier 2 European retail banks will continue to incrementally develop legacy core systems

## Market driver

## Strategic implication

**Margin pressure**



- Reduce unit costs
- Increase product standardization
- Increase product differentiation
- Margin protection via product integration / bundling

**Challenging revenue growth**



- Improve time to market
- Increase volumes
- Decouple manufacturing and distribution
- Transform customer management

**M&A slowdown**



- Window of opportunity to prioritize transformation
- Horizontal synergies – shared services / operations

**Increasing regulatory burden**



- Enhance data quality / standardization
- Embed compliance focus

In search of margins and revenue growth, major universal banks are targeting the affluent market with financial solutions

## Private banks

- Offer complete service to HNW customers
- Complex products, highly bespoke advice

## Affluent retail banking

- Retail banking businesses of major universal players.
- Targeting wealthier retail customers with strong brands, broad product range and advice
- Competition in transactional space driving quest for higher margins and renewed revenue growth

## Transactional retail banking

- Market dominated by (former) savings banks, building societies, banking co-operatives
- Focus on mass market, lower-value products (current accounts, credit cards etc)
- Worsening revenue outlook and strong margin pressure



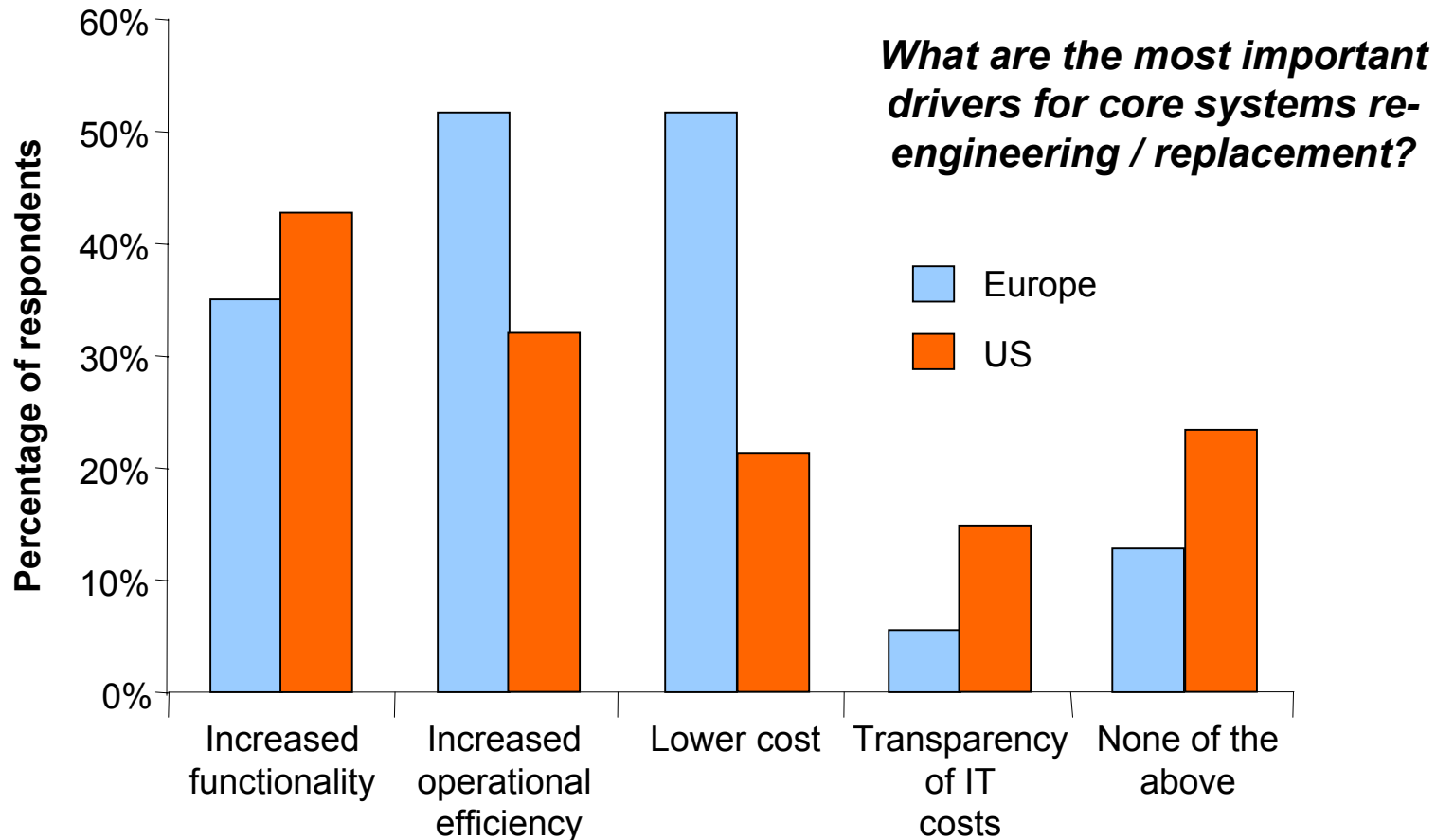
- Sales execution critical
  - Match the right product to the right customer
  - Differentiated propositions for distinct customer groups
  - Changing branch culture to build a strong, responsible sales capability
- Mass market – volumes, supported by low-unit cost operations
  - Aggressive, price-based competition,
  - Branch as a sales center - volume selling, strong sales execution, standardized advice process
  - More standardized products
  - Best-in-class unit costs
- Affluent market – customer intimacy, supported by product leadership
  - Financial solutions - cross-selling savings / investment products
  - Branch as an advice center - delivering on advice / financial planning
  - Supported by fast time-to-market, packaging of savings / investment products
  - Best-in-class connectivity



- First major cross-border acquisition between major European markets where cultural similarities are limited.
  - BSCH cleared the bar in terms of delivering synergies that were acceptable to investors
- Pushing the boundaries of IT and process transformation made it possible
  - Most successful in-market mergers have been built on aggressive IT platform consolidation
  - Almost impossible in a cross-border scenario
  - Previous cross-border IT synergies have been largely limited to infrastructure
- Exporting of process transformation, enabled by architecture / application transformation
  - Value creation from Abbey merger depends on implementation of Partenon IT platform
    - Will deliver 1/3<sup>rd</sup> of total cost savings
    - Facilitates real-time straight through processing and improved customer management
- Excellence in business transformation prerequisite for winners in the European M&A endgame
  - Ability to execute on technology-driven process transformation key differentiator

- Single core processing engine for each product area
  - Maximize economies of scale
  - Supports transition towards shared services operations / processing
  - Move towards single core processing engine for *multiple* product areas
- Standardized product development environment
  - Enable rapid time-to market
- Streamlined end-to-end processes
  - Significantly increased STP to reduce manual intervention
  - Operations transformation key to core banking replacement
- Excellence in business transformation capability
  - Ability to execute on transformation key differentiator
  - Aggressive core systems rationalization key to successful M&A
- Platform for potential cross border / bank systems standardization
  - E.g. Danske Bank, Nordea, Fortis, ING, SCH, NAG UK

Business drivers for core systems investments differ significantly between Europe and the US - efficiency-based motives lead in Europe, while US banks remain focused on functionality / time-to-market



## Transformation barrier

## Strategic implication

Business strategy - need to start with a clean sheet of paper



Significant shift in business strategy required for change

Time-to-market  $\neq$  business case



Business case must major on operations cost reduction

Long project timeframes - finding the "right time" to replace



M&A / change in strategy could lead to project postponement

Excessive resource consumption



Long-term ROI does not justify short-term costs

Lack of a demonstrable transformation track record



Negative risk / return equation

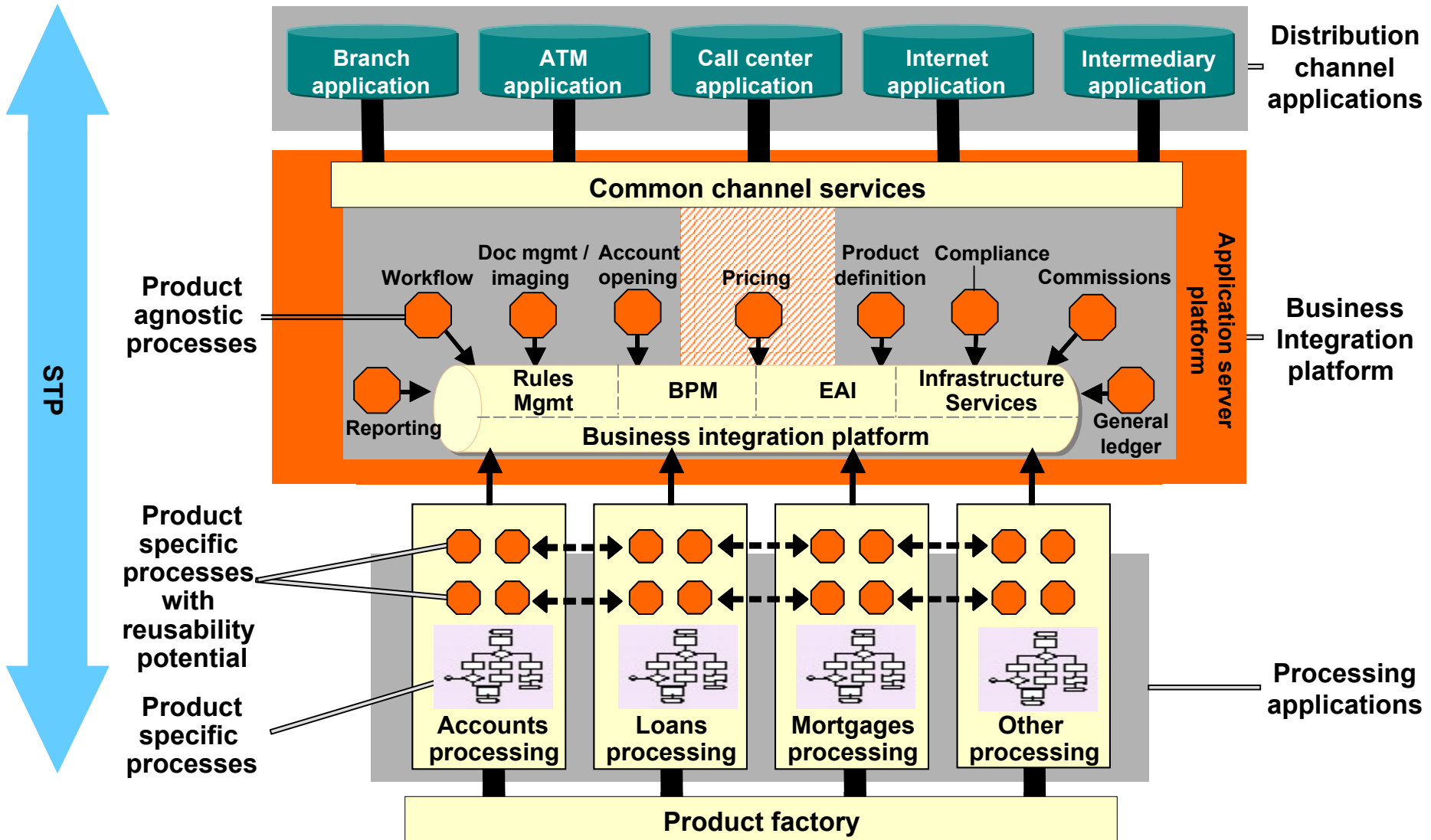
Major recent core systems investment post M&A



Further transformation investment cannot be justified

- No common pattern emerging to core systems replacement
  - Concept of a ‘core system’ is changing
- A range of core systems strategy options open to banks other than replacement
  - Wrapping, process integration, componentization, service-oriented architecture (SOA)
- Core systems strategy must be aligned with IT architecture strategy
  - Decouple front-ends from back office systems
  - Separate customer, business process, processing and product development functionality
- Move towards process driven, service-oriented architectures
  - Greater componentization of monolithic legacy applications
  - Ability to reuse / replace specific areas of core banking functionality
  - Re-use of common product-agnostic ‘enterprise components’ across the back office
  - Push core systems back in the architecture – pure processing engines

Large retail banks will migrate to service-oriented architectures



## Core systems transformation



### Componentization / SOA

#### Benefits

- Ability to implement best-of-breed vendor and internally developed components
- Allows banks to focus on replacing only problem areas of functionality
- Facilitates application development based on optimal business processes
- Allows more rapid delivery of functionality
- Bank retains architectural control

#### Disadvantages

- Technology still being proven
- Question marks over scalability
- Potential for over-complexity
- Need for high degree of architecture definition / standardization

### Traditional package

#### Benefits

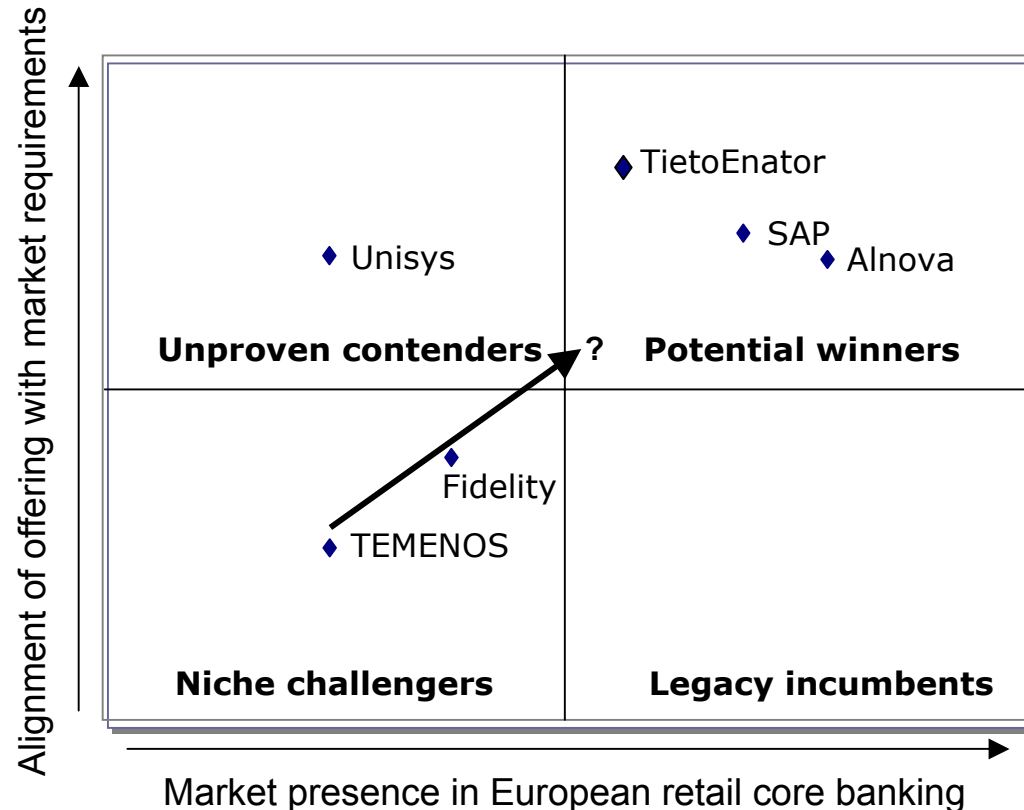
- Single vendor solution
- Inherently homogeneous architecture
- Reduced complexity
- No requirement for high degree of architecture definition

#### Disadvantages

- Forces banks to buy in to a pre-defined process framework
- May require extensive customization
- 'Big-bang' implementation a prerequisite
- Functionality may not match banks' requirements
- V. large upfront licence fee
- History of implementation failures

- Competitive threat from internal IT development in Tier 1s will strengthen
  - Banks would prefer to implement packages but...
  - External solutions perceived as high cost
  - Tendency to build for competitive advantage
- Tier 1s want to retain control over architecture, business process design
  - Component-based development plays to their perceived strengths
  - Packages too prescriptive
- Limited internal IT resources mean Tier 2s will go for packages
- Vendor offerings must move towards service-oriented paradigm
  - Banks will seek to fuse internally and externally developed components

Credibility of vendor solutions increasing, but no clear leader yet



- Although leaders are emerging, no vendor meets all the criteria to dominate the Tier 1 / 2 replacement market
- SAP, Alnova strongest on references in Europe
- TietoEnator has most well-aligned solution but limited mindshare
- Temenos most likely to emerge as a major player, particularly via IBM partnership
- Vendors lacking reference sites likely to lose out

- Run rate of Tier 1/2 core banking deals in recent years has been ~2 per year
  - Tier 1 – UBS, Swedbank, Deutsche Postbank
  - Tier 2 – BAWAG, Zurcher Kantonalbank, Gjensidige NOR, Banco Sabadell, Caixa Catalunya
- Datamonitor analysis of business and technology strategies of the 50 largest European retail banks suggests that:
  - Next 1-2 years - 4 banks out of the Top 50 will undertake major replacement projects
  - 3 to 4 year timeframe - 9 further banks out of the Top 50 will undertake major replacement projects
- Majority of all Tier 1 and Tier 2 European retail banks will continue to incrementally develop legacy core systems
  - Little likelihood of a raft of big projects in the short term
  - Too complex a market for 'follow-my-leader' to take hold

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- W. Europe
  - Core systems is a business transformation issue
  - Many Tier 1 banks will incrementally develop legacy core systems
  - Vendor offerings must move towards service-oriented paradigm in Tier 1 market
  - Tier 2 / Tier 3 banks will lead - Alnova key competitor, IBM partnership key
  - ~35 Joint use centers / outsource service providers, of which >10 currently have vendor platforms
- CEE
  - Russia / Ukraine (in particular) and second wave EU entrants key opportunities
  - First wave EU entrants - replacement of first generation vendor systems, e.g. Fiserv
  - Cross-border standardization
- Asia / Pacific
  - The big opportunity, especially China, Korea, Thailand, Taiwan
  - India (although local players likely to be too dominant)
  - Second wave, e.g. Indonesia, Vietnam, Malaysia, Philippines
- Latin America
  - Larger banks currently more cautious in replacement strategy
  - But competitive situation likely to force their hand, esp. in more developed markets e.g. Brazil, Mexico

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