



The Future Shape of Banking

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Chand Kohli maps out what banks need to do to rebuild a business model that will support their objectives and serve the wider economy.

The global financial crisis has shaken the foundations of financial services institutions to their core. Industry conditions have changed fundamentally and permanently and banks need to act quickly to develop comprehensive plans - first to stabilise their businesses and then to move forward.

Banks must decide on their strategies and how they can build the right business models to deliver them. Nothing less than a world-class approach to the management of capital, risk, regulation and governance will suffice. To help deliver their strategy, banks must focus on employing the right people, while rewarding them fairly and transparently.

Strategy

Banks must first address their own balance sheets. While banks in Ireland do not generally have substantial exposure to the type of toxic assets that caused such difficulties for many large US and European banks, exposure to development property and land has caused significant losses for them. While the National Asset Management Agency (NAMA) and the UK Asset Protection Scheme may provide more certainty as to downside risks, banks still need to secure their capital and liquidity positions, bringing assets onto the balance sheet and providing full transparency.

The economic cycle is also putting other assets under pressure. While these do not require 'ring fencing', they will need a significant amount of management time and attention. Notwithstanding these immediate challenges, banks need to review their competitive position.

The future belongs to organisations that can first identify the market segments where they can add value and where there are customers willing to pay for their products; and then have the courage to invest in these businesses while shrinking others. Effective monitoring of progress against strategic goals will be fundamental to future success; the management of change might seem mundane in these times of crisis, but implementation will, as always, be the differentiator.

Cost reduction is a priority for all banks and tools such as activity-based costing should be used to achieve a fuller understanding of the cost base. Banks should not just cut costs; they need to be strategic and seek to modernise their business. They must simplify and reduce the complexity that has built up over many years, better integrate their processes and systems, and better connect the different parts of their businesses that serve their customers. In short, they must focus on increasing efficiency rather than just relying on headcount reduction to achieve their new cost targets.

Banks must fundamentally challenge the design of their control systems and governance, which need to be simple and appropriate. If banks are not thorough and do not spend sufficient time and effort on redesigning these systems and controls where required, regulators will move to enforce very significant control frameworks on the industry.

Business model

As banks look to the future, transitional change will probably be insufficient – structural and transformational change must be considered. Regardless of changes to the business strategy, the way that strategy is delivered will certainly change.

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Transformational changes to the business and operating model are rarely undertaken, but the current environment provides a 'perfect storm' of the driving forces behind such wholesale reconstruction: dramatic adverse changes in financial performance, significant regulatory intervention and substantial changes to leadership teams.

Short-term survival is clearly critical. But, as balance sheet stability is restored, banks need to consider appropriate business and operating models that will ensure their long-term survival. The urgent need to address short-term financial considerations

can lead to longer-term mistakes when assessing which assets are core and which are non-core. Instead, these longer-term decisions on which assets are vital to the new strategy need to be derived from basic thinking around the customer value proposition and the ongoing ability of the bank to derive value from that model - having regard to the appropriate levels of risk versus reward.

Banks will need to consider the appropriate mix of products and services they can deliver and manage, where they sit on the monoline-universal bank continuum, the balance between distribution and manufacture, the ability to scale and the effectiveness of embedded control.

The future will probably bring changes in whichever part of the value chain banks choose to operate, particularly for the universal banking model, where most will recognise they lack the scale and reach to serve fully their franchise with owned product and infrastructure. The nimble, who have a fully developed, needs-based customer value proposition, will understand that packaging an appropriate set of products and services together - some of which might be white labelled from others - adds more value than providing a limited range of fully-owned products and services.

Banks need to understand clearly all the different aspects of their business and operating model because they are intertwined; decisions to change one part of the model will have significant consequences for the other aspects. This interconnectivity makes structural change highly complex and the process of change can, in itself, be a cause of operating model failure. With this in mind, banks must be wary of poorly thought through or knee-jerk reactions.

Capital, risk, regulation and governance

Capital is now a scarce commodity and the people, processes, policies and systems that govern its deployment will have to become more effective and robust. Capital and funding structures will become simpler and lower returns on equity will become the norm. Basel II will be transformed, with higher capital requirements and capital buffers that flex over the economic cycle to give better counter-cyclical protection.

There will be significant changes to the techniques used to analyse how much capital is required, particularly in relation to credit risk across the cycle and also to address the limitations of value-at-risk models. Broader funding, liquidity and operational risks are under greater scrutiny and banks will become smarter at measuring, monitoring and limiting their liquidity risks and building a better assessment of liquidity risk into their business decisions. The desire to understand risk profiles and risk behaviours is greater following the crisis and economic capital models will remain a useful tool to do this.

Banks have to face the possibility of more embedded regulation. Regulators can be expected to take a 'back to basics' fundamentalist attitude towards regulation and be more hands on and take a more international perspective. However, banks have to play their role in ensuring that regulators do not overload them with potentially damaging regulation.

The opacity of banks' organisation structures and processes has not helped in the management of their risks. In certain circumstances this problem has been compounded by ineffective non-executive director or supervisory board oversight. Governance, risk and compliance need to become more prominent. This will require a re-examination of the way that these functions are viewed. The conditions are right for this change to occur and for these functions to play a stronger, more challenging role in the governance of financial institutions. The level of tension between the second and first lines of defence can be expected to rise.

People and rewards

People, rewards and culture have without doubt played a role in the development of this crisis. Management must make it a priority to develop better ways to fairly reward staff while not encouraging inappropriate behaviour. Reforms will take significant time and effort to get right and will only deliver their full benefits in the long run.

Changes to reward systems and governance are the most urgent in the short term and are the focus of public, government and regulatory interest. Displaying a responsible and well thought through approach to

compensation will be an important part of reputation building for financial services institutions and will also play an important role in bringing about change.

Appropriate risk-adjusted measurement systems should be cascaded further down into the business, ideally to business unit level. There also needs to be a more balanced set of measures. The determination of deferred compensation needs to be brought closer to the value of the business that generated the bonus in the first place, while striking a balance between individual accountability and a partnership ethos. It is equally important that appropriate qualitative, risk-based oversight of bonus pool determination is established. The role of discretionary judgement about quality of earnings - linking information about risk with information about compensation - is vital.

Compensation will only ever be a part of a change agenda. Financial services institutions need to build strong and resilient cultures in which responsible risk-taking, within the risk-appetite of the firm, simply becomes 'the way we do things around here'. This will require different approaches to reward, development, performance management, communications and recruitment.

Conclusion

A recent analysis of banking crises internationally pointed out that the fiscal consequences of banking crises reach far beyond the immediate bailout costs in their wider impact on government revenue and the economy. The importance of developing a more robust and well-designed banking industry has never been greater for the wider economy.

The recent appointments of Governor and Head of Financial Supervision to the new Central Bank of Ireland, the planned implementation of NAMA and the outlines of the new regulatory framework from Brussels provide the context for banks in Ireland to plan their future. The need to consider their strategy has never been more urgent.