

Bank Governance Leadership Network ViewPoints

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Global banks now need to transition to materially different business models

Developing new, sustainable business models that attract long-term funding has been a theme of Bank Governance Leadership Network (BGLN) discussions since the network's inception. While uncertainty continues to complicate decision making, many agree that bank boards and management teams must begin making medium- and long-term strategic changes. One participant said, *"I am surprised that people still think there is a lot of uncertainty. The question for me is not how much uncertainty there is, but, knowing it will continue, how do we deal with the uncertainty and not simply complain about it."* Another pointed out that *"global banks are supertankers, and decisions to change course need to be made very far in advance,"* and observed further that although banks *"would like to take [change] in steps ... if you only talk about the next three years, you won't get anywhere."* While many banks continue to take a *"last man standing"* approach – that is, waiting for peers to scale back or exit businesses, thereby making their own business relatively more profitable and sustainable – this position will become increasingly untenable with an evolving macroeconomic and competitive environment. As another participant said, *"Old business models are gone: there is no more prop trading, no more miraculous products driving profitability. You need a solid business case. The future is [profit and loss] and balance sheet efficiency."*

In May and June 2013, BGLN participants met in London and New York to discuss the future of banking. They were joined by several participants from the credit rating, investor, and supervisory community, who offered their perspectives on this important topic: Greg Bauer and Johannes Wassenberg, Moody's Investors Service; Robert Hingley, Association of British Insurers (ABI); Brad Hintz, Sanford C. Bernstein & Co; Steven Manzari, Federal Reserve Bank of New York; and Mike Trippitt, Numis Securities Limited.¹

This *ViewPoints*² captures the essence of those conversations, in which four key themes were discussed:

- The fog of uncertainty is clearing
- Non-bank competitors are emerging as the foremost threat to current business models
- Boards must challenge conventional wisdom
- Banks need to bring key stakeholders along on the journey to the new normal

The fog of uncertainty is clearing

In the aftermath of the financial crisis, it has been easy, and in many ways reasonable, for banks to blame uncertainty for keeping them from making long-term strategic decisions about their business models. However, bank directors increasingly say that the overall sense of regulatory uncertainty is abating, and while certain regulatory areas remain in flux, there is enough certainty to make the necessary strategic decisions.

¹ See Appendix for a list of participants.

² *ViewPoints* reflects the network's use of a modified version of the Chatham House Rule whereby names of network participants and their corporate or institutional affiliations are a matter of public record, but comments are not attributed to individuals, corporations, or institutions. Network participants' comments appear in italics.

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Except in consumer protection, the direction and intent of regulation is now clearer

New regulation has been routinely cited an obstacle to board and management decision making. Indeed, one participant at a recent BGLN meeting described regulators as “the fog makers.” However, increasingly directors grant that the fog is clearing in most areas of regulation, and they acknowledge that the overall intent is clear: to reduce the size of banks so it is less likely that domestic taxpayers will be called upon to bail one out. One participant remarked, *“The SIFI [systemically important financial institution] surcharge is an explicit tax on size, along with enhanced prudential standards for size – size is the most fundamental aspect of systemic issues.”* One director concluded, *“The regulatory cycle is typically 10 years, so we still have at least five years to go. So, we need to look through that and start making some decisions.”*

Prudential reform is ongoing, but the major elements are known

After the global financial crisis, regulators and supervisors embarked on perhaps the most significant prudential banking reforms in 70 years, increasing capital and liquidity requirements significantly and reducing risk-weighted assets (perhaps with the notable exception of sovereign debt in Europe). Requirements for resolution regimes and approaches have been strengthened, as have governance and risk management requirements. The intensity of supervision has increased greatly, at least for the largest banks.

Undeniably, some aspects of prudential regulation and supervision remain to be determined. The recent pronouncement by the Federal Reserve that it will force banks to comply with the Basel III capital regime solidifies one area of regulation but there has also been growing international focus on leverage ratios that could force banks to hold still more capital. Additionally, there are estimates that Basel III will require that banks hold even more capital and, in total, could necessitate almost €2 trillion in new equity for United States and European banks by 2019.³ Others point out that the fine print of rules such as the Volcker Rule have yet to be agreed. Moreover, many agree that the work on ensuring large banks are properly supervised has only just begun. However, the regulatory direction is now clear, and as one bank chairman put it, *“We shouldn’t wait for the pendulum to swing back any time soon.”*

Structural reform is market specific, but the underlying direction is clear

Arguably, the area where greatest market and geographic variances exist is on structural reform. The United Kingdom looks set to institute material ring-fencing between retail and investment banking within universal banks. Europe’s zeal for material restructuring within banks – as recommended by the Liikanen Group – seems to be waning. In the United States, while there has been little appetite to restructure large banks radically, there has been a reemergence of the break-up-the-large-banks debate, even if only as political grandstanding.

However, beneath the differences, a common intent is visible: to ring-fence capital and liquidity by jurisdictions. In the United Kingdom, the Independent Commission on Banking has recommended ring-fencing local lending retail arms and applying stricter liquidity rules to foreign banks. In the United States, under the Federal Reserve’s new proposals, “Foreign banks will have to ring-fence their American

³ “Capital: How Much Is Enough?” *Economist*, May 12, 2011.

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operations into separately capitalised and regulated subsidiaries; they may also have to be separately funded.”⁴ In Europe the so-called “Swiss finish” sets firmwide capital levels at distinctly high levels. Subtle pressures to establish stronger local operations and governance structures show the same lineage. Overall, this will mean “global banks will have to maintain more capital than currently dictated by their home countries or [Basel].”⁵

At the BGLN meetings, directors highlighted the implications of these requirements. One noted, “*The challenge is the need to hold capital at the local level. If we all have to hold more at that level, the cost of capital will go up.*” Another participant questioned whether global banking models are viable with “*differences across borders ... becoming so large that managing banks is increasingly difficult and with no fungibility across borders.*”

The pendulum of consumer protection regulation has only started swinging

Consumer protection, also referred to as market conduct, remains the most uncertain area of regulation. Participants in BGLN discussions over the last 12 to 18 months have increasingly agreed that the most significant long-term regulatory threat to banking business models lies in this area. Indeed, some said its impact could be greater than higher capital requirements and ring-fencing and will extend well beyond retail banking. “[*The*] extent that [*to which society*] moves away from *caveat emptor* has enormous consequences,” one participant warned.

Some argued that this is particularly an issue in the United States and United Kingdom, with new regulators such as the Financial Conduct Authority and Consumer Financial Protection Bureau and (in the US case) existing regulators striving to make their mark in the area. “*High profit margins are seen by regulators as a sign that banks must be ripping someone off,*” remarked a participant, describing the approach to consumer protection. And there are signs that other countries may be headed down the same path, with constraints on financial advice already in place in several markets.

Macroeconomic conditions are becoming less predictable

BGLN participants are quick to note that global macroeconomic conditions remain very challenging for banks and their customers and clients. A BGLN participant said, “*The macroeconomic environment is where the fog isn’t clearing at all.*” While the United States is recovering, Europe remains fragile, and its medium-term growth prospects remain gloomy. Furthermore, key emerging markets, including Brazil, India, and China, have shown recent signs of slowing.

Beyond economic conditions, there are growing concerns about central banks’ eventual move – and in the United States in particular – to taper quantitative easing measures. JPMorgan and Deutsche Bank estimate that G7 central bankers have collectively put approximately \$10 trillion of additional liquidity into the market since 2008.⁶ This represents “an unprecedented level of simultaneous monetary stimulus – and prospective future tightening.”⁷ Though some banks remain optimistic about how they are positioned, even

⁴ “The Great Unravelling,” *Economist*, April 20, 2013.

⁵ Christine Harper and Yalman Onaran, “Global Banking Under Siege as Nations Tighten Local Rules,” *Bloomberg*, December 5, 2012.

⁶ Gillian Tett, “Fasten Your Seat Belts for a Turbulent QE Exit,” *Financial Times*, June 20, 2013.

⁷ *Ibid.*

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in the face of potential interest rate increases, Paul Miller, an analyst at FBR Capital Markets, notes that “Higher rates without meaningful economic growth are bad for banks ... [because] short-term rates that drive loan pricing could stay near record lows while assets pegged to long-term yields lose value.”⁸ Moreover, with regulators considering mandating minimum amounts of long-term debt at bank holding companies, “as overall rates rise, borrowing costs become a more pressing issue, especially if regulators decide what kind of debt banks must issue.”⁹

Non-bank competitors are emerging as the foremost threat to current business models

Many bank boards and management teams have been so focused on the changing regulatory and macroeconomic environment that they have not given due consideration to new emerging strategic competitors, including technology, telecommunications, and retail companies. One participant remarked, “*In the near term, regulation will remain a key issue, but we need to start asking who are the non-bank competitors, and how will they affect the banking sector over the next 10 years?*” Another participant observed, “*Even without Basel or Dodd-Frank, most banks would likely be undergoing significant change [because of competition and changing customer needs].*”

One participant said, “*Technological change is changing the game.*” As Peter Sands, group chief executive of Standard Chartered recently wrote, “Banks and their regulators are going to have to embrace technology-driven innovation ... Otherwise it will simply happen by stealth, driven by players outside the industry.”¹⁰ Changing technology has created new types of competition and has changed the way customers make decisions about financial services. Another participant noted, “*There has been a disintermediation of human interaction. Because human relationships have been distanced, it’s harder to prioritize consumers that are further away and possibly less of a concern.*” As an example, one participant pointed to the mortgage market, where “*if you look at the third-largest originator of mortgages, it is now Quicken loans.*” A participant stated, “*[There is] a huge opportunity for banks to determine what range of products and services they want to offer, going forward.*” Now is the time, another participant said, to ask, “*What do customers really want from banks? What value can banks create for customers?*”

Participants in the BGLN meetings recognized that banks’ new competitors have certain advantages:

- **Technologically adept.** For many new competitors, technology is a core competence, and they invest heavily in systems improvements. By contrast, banks are often hampered by costly legacy systems that require considerable maintenance. One participant remarked, “*Banks are the largest technology companies in the world, but they are not run that way. Technology does not lead discussions at the top levels.*”
- **Customer centric.** Competitors tend to have a strong focus on customer needs, have petabytes of data on customer preferences at their disposal, and are accustomed to employing big-data analytics.

⁸ Dakin Campbell and Christine Harper, “[Bank Profit Seen Buffeted by Rates Rising Without Growth.](#)” *Bloomberg*, June 16, 2013.

⁹ Lex, “[US Banks: Holding Pattern.](#)” *Financial Times*, June 16, 2013.

¹⁰ Peter Sands, “[Banking is Heading Towards its Spotify Moment.](#)” *Financial Times*, June 30, 2013.

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- **Strong brands.** Banks have greatly tarnished reputations, poorer than companies in any other major sector of the economy,¹¹ whereas many new competitors are well admired.
- **Unencumbered by regulation.** One participant said, *“It comes back to regulation: every company’s highest risk is around regulation, and it revolves around uncertainty. It will be hard to compete with [telecommunication companies] with uneven regulation – how do those conversations become part of the regulatory debate?”* Additionally, banks are finding long-standing practices, such as cross-subsidization, cross-selling, and product bundling, coming under more intense scrutiny. By contrast, technology and telecommunication firms remain lightly regulated and have been innovative in their use of sales and marketing practices.
- **Deep pockets.** Many large technology and telecommunication firms have significant stockpiles of cash, so they can ably withstand the initial costs of building a financial service presence. For their part, pension funds and asset managers have large and growing pools of client assets that can be leveraged into areas of financial services that have traditionally been the domain of banks, notably corporate lending.

The growing threat of new entrants is most striking in retail banking

The retail side of banking is facing perhaps the most significant competitive threats. Technology is enabling customers to satisfy their banking needs in different ways and is reducing the barriers to new entrants. Those new entrants generally fall into three categories:

- **Firms with a large retail-store presence.** Large retailers have made a concerted push into financial services, particularly in the United Kingdom and United States. In the United Kingdom, Tesco recently announced that it will be offering mortgages, taking the company “closer to its goal of building a fully functioning bank.”¹² The UK Post Office recently announced that it will offer current accounts, “a move that will greatly expand [its] presence in financial services, on top of its existing reputation as a trusted savings provider.”¹³ In the United States, American Express and Wal-Mart announced in March that Bluebird, their joint venture offering prepaid cards, has qualified for federal deposit insurance, allowing the retailer to offer a wider selection of financial services in the United States.¹⁴ With a federal deposit insurance guarantee, Wal-Mart has taken a major step toward becoming an alternative provider of banking and card services, particularly as prepaid cards are less regulated and exempt from debit restrictions imposed under the Dodd-Frank Act.
- **Technology companies.** The likes of Google, Apple, and PayPal have demonstrated interest in luring customers away from traditional retail banking providers. The increasing adoption of near-field communication technology could accelerate their ability to gain a “share of wallets.” These tech giants, according to Deutsche Bank, “are doing exceptionally well in integrating changing patterns of consumption and media use – especially of internet-savvy consumers – into their offerings. They thus

¹¹ Heather Landy, *“American Banker’s 2013 Survey of Bank Reputations,”* *American Banker*, June 25, 2013.

¹² Sharlene Goff, *“Tesco Adds Mortgages to Banking Stable,”* *Financial Times*, August 3, 2012.

¹³ Elaine Moore, *“Post Office to Offer Current Accounts,”* *Financial Times*, April 10, 2013.

¹⁴ Wal-Mart Stores, *“American Express and Walmart Announce the Addition of FDIC Insurance and Worry-Free Check Writing to Bluebird,”* news release, March 26, 2013.

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might represent serious competitors in the (future) market for standardised financial services.”¹⁵ As a proxy for this type of competitor, Google Wallet gained much attention at one of the BGLN meetings, with one director concluding, “*I need to find out more about [it] – I’ve never heard of it, but apparently it’s a major strategic threat to our banks.*”

- **Telecommunications companies.** Firms like Verizon are beginning to invest heavily in their financial service, both in developed markets and in the developing world, where the use of mobile technology is enabling faster economic growth by reducing the limitations presented by weak infrastructure. While only a small percentage of consumers in developing countries own a credit card or have a bank account, in 2009, mobile device penetration surpassed 50% in the developing world.¹⁶ According to a recent report by Juniper, handset penetration in central and eastern Europe is 119% and 125%, respectively, but only 89% in the United States.¹⁷ Mobile commerce transactions are growing nearly 20% year on year, presenting an enormous and irresistible opportunity for new entrants.

Corporate, investment, and private banking are also facing new competitive pressures

The competitive threat to corporate, investment, and private banking comes from the following areas:

- **Trading revenues.** In 2009, G20 leaders agreed that “All standardised [over-the-counter (OTC)] derivatives contracts should be traded on exchanges or electronic trading platforms, where appropriate, and cleared through central counterparties by end-2012 at the latest.”¹⁸ The aim is to safeguard markets against systemic risk and create more standardized swap processes through clearinghouses for nearly \$600 trillion of OTC products. As they are implemented, new regulations will significantly affect large banks. One participant predicted that as standardized derivatives increasingly move to central counterparty clearinghouses, pricing will become more transparent, reducing the information asymmetries that give banks an advantage and lowering profit margins. Another participant concluded that the “*revenue stream from over-the-counter securities is going away*” and predicted that “*proprietary trading [revenues] will go away, too.*”

There is concern in the industry “over the potential of more onerous treatment of off-exchange products like swaps compared to their close listed counterparts, futures, under the rules proposed by the CFTC [Commodity Futures Trading Commission],”¹⁹ with cleared swaps likely to require more margin than listed products. Asset managers will also use technology to compete more directly with banks in bond trading, as described in the *Financial Times*: “As banks are being increasingly reined in by new

¹⁵ Thomas Dapp, Antje Stobb, and Patricia Wruuk, “[The Future of \(Mobile\) Payments: New \(Online\) Players Competing with Banks.](#)” *Current Issues*, December 20, 2012, 2.

¹⁶ International Telecommunication Union, “[New ITU Report Shows Global Uptake of ICTs Increasing, Prices Falling.](#)” news release, February 23, 2010.

¹⁷ Lauren Johnson, “[Mobile to Exceed \\$3T in Transactions by 2017: Juniper.](#)” *Mobile Commerce Daily*, June 20, 2013.

¹⁸ Financial Stability Board, [OTC Derivatives Market Reforms: Fourth Progress Report on Implementation](#) (Basel: Financial Stability Board, 2012), foreword.

¹⁹ Philip Stafford, “[GFI Seeks to Mitigate Derivatives Regulation.](#)” *Financial Times*, April 5, 2013.

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regulation, buy-side groups find themselves with a wider range of opportunities.”²⁰ For example, BlackRock recently pioneered an individual bond trading platform and launched a new partnership with MarketAxess, the largest independent platform for electron bond trading, “to facilitate trading between investors without an investment bank as a middleman.”²¹

- **Corporate lending.** In Europe, where companies remain heavily reliant on banks for funding, the financial crisis also opened up an opportunity for asset managers, “many of them attached to insurance companies, [which] are increasingly looking to lend directly to companies.”²² In the United States, as “tightened lending standards, coupled with a stricter regulatory environment, have curtailed banks’ willingness to extend credit,”²³ asset managers have stepped in to fill a lending gap to midsize companies (\$10 million to \$1 billion). Increasingly, the firms are developing retail-focused funds that gather assets from consumers, enabling consumers to invest more directly in corporate lending opportunities, alongside other alternative investment investments.
- **Private banking.** As many large banks seek to grow their presence in wealth management, private banking operations are facing not only more regulation (in the form of the Foreign Account Tax Compliance Act, the Markets in Financial Instruments Directive, and Basel III), but also “a tougher, more competitive market.”²⁴ In Europe, for example, insurance companies “have stolen a march on some wealth managers with a simple advisory-driven business model.”²⁵ New Internet-based competitors are also emerging, including Money Guidance and Nutmeg, which have minimal costs and advocate wealth management approaches based on index tracking. Though it is unlikely that the centuries-old model of private banking is due for transformational change, new entrants and innovative business models will likely make this an increasingly competitive realm of finance.
- **Vendor and supply chain finance.** Large corporates have long had captive finance companies to support their customers’ purchases, thereby directly competing with bank lending departments. However, more recently, competition in vendor finance has moved to smaller customers. For example, in late 2012, Google launched its first foray into the credit business, offering its own credit card and signaling “the company’s first attempt to use its huge cash reserves to support its core search advertising business by subsidising low-interest rate credit lines.”²⁶ Additionally, Amazon has indicated that some of its recent lending was “aimed at credit-starved businesses that would otherwise struggle to finance initiatives such as expanding the inventory of products they sold on its site,”²⁷ and eBay has also started offering competitively priced credit to its sellers.

²⁰ Tracy Alloway, “BlackRock Edges into Banks’ Territory,” *Financial Times*, October 1, 2012.

²¹ Kirsten Grind and Telis Demos, “BlackRock Retreats from Bond-trading Platform,” *Wall Street Journal*, April 23, 2013.

²² Mary Watkins, “Asset Managers Lend Directly to Business,” *Financial Times*, November 3, 2012.

²³ Julie Steinberg, “Seeking Yield in Direct Loans,” *Wall Street Journal*, January 4, 2013.

²⁴ Daniel Schaefer, “Business Models: New Entrants Pose Challenge to Old Guard,” *Financial Times*, May 8, 2012.

²⁵ *Ibid.*

²⁶ Richard Waters and Barney Jopson, “Google Makes First Foray into Credit Business,” *Financial Times*, October 8, 2012.

²⁷ *Ibid.*

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- **Payment processing.** The market for mobile payments is in its infancy, but it remains a disruptive threat to the existing payments system. One participant remarked, *“Players such as eBay, Apple, and Google, with all of their expertise in dealing with electronic payments, could create competitors for banks’ profitable payments systems.”* PayPal, for instance, states that it has 125 million digital wallets²⁸ and with its global reach, it is a potentially formidable competitor. In a special report, Matthew Lindsey-Clark, senior managing director of European financial institutions at Evercore Partners, described the situation: *“The search engine giants and [telecommunication firms] are looking to suck out the non-lending profits from the payments business without needing a balance sheet. This is the next battle.”*²⁹

Boards must challenge conventional wisdom

While several participants called attention to the major changes that a number of banks have already undertaken, others stressed the necessity for even more drastic change and asserted that most banks have only tweaked their business models at the margins. One participant recommended that management teams do some serious reassessment: *“What are the long-standing assumptions and conventional thinking in firms that are no longer accurate?”* Participants identified three assumptions that should be challenged: banks can reprice their products and services; banks are already very efficient; and the room for strategic maneuvers is limited.

Banks can reprice their products and services

The natural management reaction to significant strategic changes is to consider repricing options. The thinking is that as costs increase and direct competitors reduce their market presence, there should be room to alter the pricing of products and services to reflect the new norm. In some areas, this has been possible. For example, several participants in BGLN meetings have noted that so-called covenant-lite loans may have come back, but at far better pricing.

However, directors recognize that the industry may have lost some of its pricing power. One participant said, *“Demand will still be there [but banks must] figure out the cost and find a pricing structure that works to cover the cost of capital ... But are there other people out there who can lend at a lower cost and lower prices than the banks?”* Another participant said, *“If you take each element of what banks do, who will offer it more cost-effectively? Are we a bit like department stores because the equivalent of niche retailers will pick away parts of our business?”* Another participant asked, *“Who will erode ability to reprice?”* The answer, this participant said, is *“anyone who can provide credit, hold deposits, and sit outside regulation. Or ... anyone with a large pile of cash.”*

Reputational issues also constrain banks’ ability to address pricing. Nowhere is this more striking than in checking accounts. Banks would like to free themselves from the shackles of so-called free checking or free banking, which banks in the past subsidized with other charges, such as overdraft fees. Now that such fees

²⁸ April Dembosky, *“PayPal Eyes in-Store Retail Customers,”* *Financial Times*, March 28, 2013.

²⁹ Philip Alexander, *“Global Banking Five Years from Now: Forecast,”* in *“A New Map for Global Banks: Regulation and Strategy,”* special issue, *Banker*, January 2013, 12.

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have come under attack, several large banks have tried to reprice these services unsuccessfully – even though they would likely benefit customers in terms of transparency.

Banks are already very efficient

In light of increasingly costly regulatory requirements, nimble new entrants with low cost structures, and general pressure on returns on equity (ROEs), banks need to run far more efficiently to remain viable. At several past bank director summits, the issue of productivity and efficiency has been central to discussions of the broader challenges facing banks, and many have said the industry has not gone far enough. To some, it is a matter of utmost importance: at a recent BGLN meeting, a participant said, *“Financial services lives and dies by efficiency.”*

While many banks have reduced headcount and assets, and in some cases exited businesses, participants said there is room for further improvements: *“There are two sources of cost: one, capital; and two, banks are incredibly inefficient. We need to build a cost structure that is very different than the past.”*

One possibility is more effective use of technology to drive efficiency through automation – what a participant called *“the new optimality.”* Currently, many banks’ IT systems are what one participant disparagingly called *“outdated spaghetti.”* Many large banks have been forced to cobble together legacy IT over multiple acquisitions, integrations, and decades of patches. Another participant noted the need to *“distinguish between front-office technology, which is better because of competition, [and] back office technology, which is old and woeful.”* However, correcting that imbalance is difficult as customers, who see the front end, consistently demand new technology and view advances in convenience, access, and flexibility as important differentiators when evaluating a banking relationship.

Banks may be rewarded for taking the plunge and investing significantly to replace old systems. One participant concluded, *“The amount of money that needs to be invested is small relative to the enormous amounts of legal and infrastructure costs that burden current large banks.”* Another agreed, saying new technology *“may make it easier and cheaper to address legacy issues than we think.”*

Talk of efficiency and cost structures naturally leads into the evergreen debate about the branch model. People have long predicted the demise of the branch, but it has proved tenacious. In the United States, the number of branches grew 22% between 2002 and 2012 to almost 90,000, and many European countries have seen similar – and in some cases, faster – growth.³⁰ Many bank executives believe the trend will continue. Last year, Wells Fargo Chairman and CEO John Stumpf said, “Location is still the first and most important decision-maker when you choose your branch.”³¹ BNP Paribas Chairman Baudouin Prot agreed, saying, “Most of the customers still want a branch somewhere nearby.”³² However, the new economics of banking may give the branch its hardest test over the next decade or so. The branch network constitutes a major part of large banks’ operating costs, yet Bain & Company estimates that as much as 90% of today’s

³⁰ [“Withering Away.”](#) *Economist*, May 19, 2012.

³¹ *Ibid.*

³² *Ibid.*

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branch transactions could migrate online.³³ At the BGLN meetings, participants acknowledged a generational shift toward mobile and online banking. One participant asked, “*What is the franchise model in retail besides customer inertia using the current branch model?*”

The room for strategic maneuvering is limited

BGLN participants also question the assumption that banks have little room in which to maneuver. In many cases, the “truths” people cite as evidence supporting that assumption should themselves be questioned:

- **Do customers always want a full-service offering?** Management teams often reason that they stay in low-return businesses because those businesses are part of a suite of offerings that the customer demands, and some of these businesses are essential loss leaders for higher-return businesses. There is some merit in this thinking. One participant observed, “*There are good businesses and bad businesses, but they’re pulled together by bungee cords. If [a bank] gets out of fixed income, don’t assume [it will] be able to keep all high-margin businesses (M&A and underwriting).*” However, some directors are beginning to balk at this truism. A participant asked, “*How critically important are risk-creating businesses to the franchise, and where do you want them to be? What is the real value proposition?*” Another said, “*You can argue you need to be all things, but you can also say [that customers are] going to look at the lowest-cost provider of a particular product, and it becomes fragmented.*” Another added, “*Even if one buys the bungee argument, one doesn’t have to have large operations in every area – just enough is fine in some areas.*”
- **Are alliances always bad news?** As illustrated by the Wal-Mart example mentioned earlier, competitors are very willing to use alliances and joint ventures to enter banking. Banks are less keen. One director said, “*Many banks don’t believe they can do things through alliances or joint ventures – that’s the conventional wisdom.*” However, it may be time to reexamine this thinking. One participant asked, “*Should we just focus on what we are strong in and create alliances?*”
- **Once a business is exited, is there no going back?** Directors and executives naturally worry about subscale operations. Smaller global fixed-income, currency, and commodities (FICC) trading business may become unsustainable if impending regulation causes too great a decline in revenue. A recent report by Deutsche Bank concluded that “all investment banks with a market share of less than 6% in the FICC trading industry run the risk of being forced to shift their trading shops.”³⁴ Management has often said that it is difficult to reverse a decision to exit, a view that one BGLN participant supported, comparing UBS, which is exiting businesses, with Goldman, which is not:

Goldman described what’s happening as running their trading desks as long-running options. Regulations are changing the economics of the business – they can automate, they can fine-tune their balance sheet – but in the end, [regulation] will change the economics of each trading desk and those of competitors. [So] Goldman says it will be in the trading world, but we don’t know

³³ Kayla Tausche and Jesse Bergman, “[A New Era of Branch Wars at Nation’s Big Banks.](#)” *CNBC*, April 10, 2013.

³⁴ Trefis, “[Deutsche Bank: The Bond Industry’s Reform Will Lead to Further Consolidation.](#)” April 30, 2013.

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where profitability will be – it will be an option, because it's irreversible once you exit the business.

But others questioned this thinking, noting that it is costly to retain talented staff and keep them motivated while revenues are down, whereas, they argued, *“We can always acquire operations in the future.”*

Do we have the right people to make necessary changes?

A new generation of executives is now running many of the world's largest banks. These new leaders have the implicit trust of their boards, which, at a minimum, appointed the CEOs and support their management teams.

However, reflecting on the enormity of the strategic challenges ahead, BGLN participants acknowledged that the incumbent management may lack the experience necessary to make the long-term transition. One participant remarked, *“What’s everyone doing? They’re not changing business models; they’re cutting costs and being more efficient with RWAs [risk-weighted assets].”* Participants reiterated that while this is a part of the equation, lowering costs alone is not enough. *“There are some real questions that are fundamental to the banking model that have not been addressed,”* one said. Some lamented the passing of the old guard: *“In most cases, the people with the best perspectives are now retired.”*

To the extent this is true, it suggests a flaw in the industry's executive talent development model. Many banks' approaches limit managers' exposure to, and knowledge of, the entirety of the business: *“The investment banking guys don't know the retail issues, and vice versa.”* But fixing the model will not be easy, in part because compensation models on either side of the business can differ substantially, and attempting to address that problem inevitably raises broader compensation issues.

Banks need to bring key stakeholders along on the journey to the new normal

The journey to a *“new normal”* is likely to be rocky and long. Boards and management teams will need to engage customers, regulators, politicians, and the public at large along the way. Without garnering their support, the industry will have a hard time regaining momentum.

Capital providers: shareholders and debt holders

Directors have become increasingly worried about the challenges of getting capital providers – shareholders and debt holders – on the banks' side as ROEs remain below their cost of capital. While banks can shed assets to close the gap or can cut costs – perhaps by addressing compensation costs – they will eventually still need fresh capital. A recent report by the Association of British Insurers raised concerns about the ability of UK banks to generate ROEs above their cost of capital.³⁵ While the report focused on the United Kingdom, similar doubts apply to banks in every developed market. The Prudential Regulation Authority

³⁵ Louise Armistead, *“British Banks Becoming Uninvestable, ABI Warns,”* *Telegraph*, November 17, 2012.

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has told UK banks to find an additional £13.4 billion of capital in 2013,³⁶ and Berenberg Bank recently reported that European Banks need at least €350–€400 billion of new capital,³⁷ so finding sources of capital will be a top priority.

Investors will want to know more about how capital is deployed and how effectively banks are using it in the new era. One participant who has spent time with major investors reported, *“Investors are saying, ‘You are too complex; we don’t understand your cash flows, so why should we invest?’”* Another participant added, *“Investors find it difficult to understand banks – they don’t understand their assets, capital, so how can they understand their return characteristics?”* A lack of clarity regarding how Basel III and new liquidity and leverage requirements will be implemented in different markets is making it harder for investors and analysts to estimate what returns will be. There is also little clarity around risk weighting (according to one estimate, large banks need 200 million calculations to determine their capital needs³⁸) which makes inter-bank comparisons near impossible. Similarly, it is difficult for investors to calculate what capital levels are sufficient to ensure safety and soundness, which should lower the cost of capital while also constraining profitability and growth. Thus in the near-term, this means banks that increase capital ratios may not see an immediate market benefit.

Investors also seek a high level of disclosure, bolstered by regulators, such as the Financial Stability Board’s Enhanced Disclosure Task Force, which issued a report in 2012 identifying fundamental principles that “provide a firm foundation for developing high-quality, transparent disclosures that clearly communicate banks’ business models and the key risks that arise from them.”³⁹ However, some participants remain skeptical about the degree of transparency possible in modern banking. One participant said, *“To some extent, you will always have a high degree of opacity no matter your disclosure. [To make] a multi-trillion-dollar balance sheet with millions of transactions ... digestible to an investor ... requires discretion in what you [disclose] ... How do you reflect quantitative and qualitative risks of lending?”*

Bank boards may have to engage long-term investors directly as they determine their bank’s future and develop a transition plan. A participant remarked that banks *“really have to ask themselves what is the right business activity for their specific type of specific funding. A broader base of funding has implications for the type of business model you’re running.”* One participant asked, *“In the transition period, how will [banks] keep debt and equity holders on board, assuming they’re fully involved and not just looking for yield?”* Another participant said, *“It seems banks have to make a case about stability. Banks have to set out a clear medium-term strategy and make a convincing case why it will work and the return characteristics the bank will have. That banks are safer is part of the story. But, as yet, investors don’t seem to buy the safety case.”*

Regulators and supervisors

There was general agreement that engaging regulators is important. One participant said, *“Regulators have been the constable [since the financial crisis]; they must instead be a partner and stakeholder.”* Another

³⁶ Adam Jones, Patrick Jenkins, and Brooke Masters, *“UK Banks Told to Find Further £13 bn.”* *Financial Times*, June 20, 2013.

³⁷ Nick Anderson and James Chappell, *“Capital: Misunderstood, Misused and Misplaced.”* *Berenberg Equity Research*, June 12, 2013.

³⁸ Lex, *“Bank Capital: Restoring Trust.”* *Financial Times*, June 20, 2013.

³⁹ Enhanced Disclosure Task Force, *Enhancing the Risk Disclosure of Banks* (Basel: Financial Stability Board, 2012), introductory letter.

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participant added that banks need to engage *“regulators as partners as we develop the new banking model. They are as important as the customers in this regard.”*

The banking industry has much to gain from positive interaction with regulators. Banks can and should push back against ill-conceived new regulation, but there is far more to gain through cooperating in developing new solutions, rather than simply opposing others’ solutions. Many participants were concerned over what they characterized as regulators’ limited vision of the industry’s future. One said that regulators *“look at the problems, but not the consequences [of regulatory action].”* There was general agreement that more engagement with regulators could help them see the consequences of increased regulation, including restrained lending and changes to the competitive landscape that favors small banks or shadow banking.

Politicians and the public

Some in the industry are determined to maintain their current course and ride out the storm of negative backlash caused by the financial crisis. They view anti-bank sentiment as transient – as one director put it, *“Once unemployment is back down to 5.5%, this will go away.”* However, a growing minority in the industry advocate a more systematic, broad-based campaign to positively influence public opinion, with one saying, *“Big banks need a coordinated approach – a fact-based communications strategy.”* The goal of such an effort would be to emphasize the critical role of banking in society and the value of large banks and their contribution to growth. *“We should better sell the value proposition of banks,”* one director said. An information campaign would also give banks an opportunity to share what one director called *“correcting commentary”* – that is, commentary that dispels some of the myths and half-truths surrounding the industry.

Regulatory reforms have already bitten into the banking industry and will continue to do so. Meanwhile, macroeconomic uncertainty continues to get in the way of decision making – but decisions must be made. Bank boards and management teams must plan for the future – at least for the next three to five years – and implement the strategic changes necessary for success. They need to be much more aware of the competitive and technological challenges that face the industry and must not let themselves become too preoccupied with regulation. There are certainly potential disadvantages to being the first mover – as one director said, *“There are many firms who have gone first and no longer exist. Being second may be a good strategy in this industry.”* But directors at both recent BGLN meetings agreed that *“one doesn’t want to be the last maker of buggy whips.”*

As a thought experiment, directors might consider the possibility of another financial crisis. All it might take is another significant control or ethical breakdown, such as the “London Whale” or Libor-rigging scandal. One participant remarked, *“The journey since 2008 continues, and the potential for tail risk in the short term is very high. The sentiment right now is so anti-bank that something that would not have been a big issue 10 years ago will be a big problem.”* Another participant observed that *“there have been a lot of backward-looking elements in recent regulation, and there could be another wave of financial regulation because there hasn’t been structural reform.”* The new wave would likely have two new characteristics: it would be truly systemic in nature, also covering shadow banking and perhaps non-banks, and it would likely

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approach regulation from a functional rather than a legal-entity perspective, focusing on what services and products firms offer rather than on the nature of the provider. It is not hyperbole to state that the strategic decisions currently being taken by boards and management are the most important, both for the industry and the global economy, in recent memory.

About this document

The Bank Governance Leadership Network (BGLN) addresses key issues facing complex global banks. Its primary focus is the non-executive director, but it also engages members of senior management, regulators, and other key stakeholders committed to outstanding governance and supervision in support of the mission to build strong, enduring, and trustworthy banking institutions.

The BGLN is organized and led by Tapestry Networks with the support of EY as part of its continuing commitment to board effectiveness and good governance. Tapestry Networks and EY are independent organizations. Tapestry Networks is a privately held professional services firm. Its mission is to advance society's ability to govern and lead across the borders of sector, geography, and constituency. EY is a global leader in assurance, tax, transaction and advisory services to the banking industry.

ViewPoints aims to capture the essence of the BGLN discussion and associated research; it is produced by Tapestry Networks. Those who receive *ViewPoints* are encouraged to share it with others in their own networks. The more board members, senior management, advisers, and stakeholders who become engaged in this dialogue, the more value will be created for all.

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Appendix: Meeting participants

Directors and executives

- W. Geoffrey Beattie, RBC
- Andrea Beltratti, Intesa Sanpaolo
- Norman Blackwell, Lloyds Banking Group
- Nathan Bostock, RBS
- John D. Coombe, HSBC
- Simon Fraser, Barclays
- Michael J. Hawker, Macquarie Group
- Robert H. Herz, Morgan Stanley
- Laban P. Jackson, Jr., JPMorgan Chase
- Callum McCarthy, ICBC
- Donald T. Nicolaisen, Morgan Stanley
- Leslie Rahl, CIBC
- Sarah Russell, Nordea
- Anthony Santomero, Citigroup
- David Sidwell, UBS
- Diana L. Taylor, Citigroup
- Kathleen P. Taylor, RBC
- John Tiner, Credit Suisse
- Nout Wellink, Bank of China

Other participants

- Gregory W. Bauer, Moody's Investors Service
- Robert Hingley, Association of British Insurers
- Charles B. Hintz, Sanford C. Bernstein & Co.
- Mike Trippitt, Numis Securities Limited
- Johannes Wassenberg, Moody's Investors Service

Regulators

- Steven Manzari, Federal Reserve Bank of New York

EY

- Ian Baggs
- Robert Cabbage
- Lawrence Prybylski
- William Schlich

Tapestry Networks

- Dennis Andrade
- Christopher McDonnell
- Mark Watson
- Charles Woolcott