



A GLIMPSE INTO FINANCIAL SERVICES INDUSTRY

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“Everything flows and nothings stays.....You can’t step twice into the same river”

As we experience dynamic changes in the financial sector, it is indeed very appropriate that the Association of Professional Bankers has decided to hold this year’s convention with the theme of “Lankan Banking – A Paradigm Shift”.

“Paradigms are powerful because they create the lens through which we see the world” says Stephen Covey. A paradigm shift, instantaneous or developmental, creates a powerful change in the way of seeing the world. With the continuous changes in the external environment the Banks too are compelled to experience a paradigm shift, a change in the manner in which they reach their markets, if they strive to retain or expand their market share.

Based on a few surveys carried out by KPMG on topics which are relevant to the present Financial Services (“FS”) markets, I have endeavoured to provide a summary of some key challenges faced by the Banks today.

1. Global Key Issues

1.1 Growth and Business Development

In the recent times the FS companies were hit hard and they embarked on a process of cost cutting and retrenchment in order to try and compete effectively and in many cases, survive. Economic and market recovery now enables companies to focus on more aggressive strategies with a change in focus from mere survival and damage limitation to growth and business development. Restraints to growth still exist across the financial services industry, and success will only be achieved by overcoming these hurdles.

Issue:

- Increased regulatory pressures, higher capital costs, a tougher competitive environment, excess capital and the need to expand following a period of cost cutting and retrenchment in many sectors will ensure that restructuring will remain central to the strategic intent of the majority of FS companies

Impacts:

- A number of high profile Mergers & Acquisitions (“M & A”) deals have recently been announced



- Future M&A activities are likely to focus on concentrated targeted acquisitions/mergers rather than large organisations merging purely for scale
- Companies will also look to grow through inorganic means and focusing on customer retention, efficient customer acquisition and deepening wallet share will remain key
- Competitive pressures mean that sub-scale operations (e.g. smaller private banks) must expand or exploit specific niche profit-pools to survive

1.2 Efficiency and Cost Management

Recent industry pressures ensured that efficiency and cost management reached the top of FS companies' executive agendas as they tried to maximise revenue generation, or minimise losses, in the face of falling sales and increasingly squeezed margins. The price competitive nature of the industry and the more costly ways in which consumers want to interface with their FS providers have ensured that driving out further efficiencies has remained key during the current period.

Issue:

- As a result of increased competitive pressures, uncertain equity market performance and the squeezing of margins, competitors in all segments of the FS market have undertaken significant initiatives in order to contain costs and drive out efficiencies

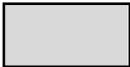
Impacts:

- Operational re-alignment has generated significant efficiencies for many
- Outsourcing, including offshoring, has proved popular not just for contact centres but also for an increasing number of middle and back office functions
- The decision to outsource, including offshoring, must also embrace non-cost related factors such as robust operational processes and client experience, in order drive out the maximum benefit

1.3 Risk & Capital Management

Risk & Capital Management are core process at the heart of every successful business and should be integrated into corporate strategy and organisational culture. Increasingly, regulators and stakeholders are expecting nothing less although many companies are still viewing it merely as a regulatory compliance issue.

Companies are dealing with many challenges in this area such as the need for efficient capital management, tackling market risk in relation to complex financial instruments and uncertain equity markets, growing concern over consumer debt and continuing large credit losses.



Issue:

- Risk is fundamental to the FS industry especially in a number of specific areas such as continuing large credit losses due to bankruptcies, growing concern over consumer debt and the risks associated with excess capital

Impacts:

- Development and use of sophisticated tools and techniques to manage and mitigate risks whilst maximizing the return on capital
- Continued development of credit risk management techniques
- Need for a greater understanding of market risk in relation to complex financial instruments and volatile and uncertain equity market performance

1.4 Corporate Governance & Reporting

Issues:

- FS industry is arguably the most highly regulated in the world. The ever changing regulatory landscape provides a key driver in the financial sector's strategies, processes and organization
- Following highly publicised failures in corporate governance and internal controls, the global investor community and clients are demanding higher standards of accountability, behaviour and performance

Impacts:

- The sheer number of regulatory requirements for many geographies and FS segments means that companies are increasingly taking an integrated approach rather than reacting to a specific regulation in isolation
- Companies must gain confidence of capital markets by explaining values, risks and the link between objectives and performance

1.5 People Management

Issue:

- After several years of deep cost cutting CEOs are increasingly focusing on making the best use of their human capital. Issues such as flexibility, cost, employment risk, attracting and retaining quality staff and corporate culture remaining key

Impacts:

- Many companies are developing and implementing a more analytical approach to managing the workforce in order to link directly human capital to business outcomes
- Increasingly mobile workforce subjected to tax regimes from a number of countries throughout a single career
- Difficulties acquiring and retaining quality technical staff and managers. Many FS companies are turning to 'outsiders' for leadership roles and many are suffering the consequences of laying off experienced technical staff



2. Driving Business Synergies through Risk and Compliance Initiatives

Tens of millions of dollars are being spent companies in the FS sector on risk and compliance projects but, is this massive expenditure leading to improvements in business performance? Or, have companies focused primarily on meeting their time critical compliance requirements with little emphasis on achieving business benefits?

Companies who adopt a minimalist approach will fail to reap business benefits if there is:

- A lack of strategic focus on compliance initiatives;
- A lack of an organisation-wide view of risk;
- An inability to use existing processes, structures, and information effectively; and
- An inability to leverage organisational learning and experience.

From our research, we have identified ten principles of leading practice which we believe will assist organisations to redress the current imbalance between compliance and performance.

i. Business strategy before compliance

Leading organisations are adopting a strategic mindset when planning compliance projects. They do not let compliance dictate business strategy, but find ways in which compliance can be accommodated within their strategic goals.

Corporate level governance

Leading organisations have established a corporate-level governance model for their compliance projects, even if the majority of implementation is carried out by the business units.

Do the homework first

Leading organisations are putting in the investment 'up front' to understand systematically the scope and the potential corporate impact of the compliance projects.

End-to-end business process ownership

Allocating responsibility for end-to-end ownership of business processes is emerging as leading practice in financial institutions, whether enterprise-wide, or within business divisions.

. Full cost transparency

Leading organisations realise that transparency of the full costs of compliance projects is necessary to ensure that the significant investment being made is visible at the most senior executive level and to the Board.



vi. *Grab them by their measures and their hearts and minds will follow*

Leading organisations are moving beyond simply 'ticking the box' of compliance, to creating a culture of protecting the enterprise and its customers. They want their people to embrace a much wider ethical, strategic and risk aware approach to their operations.

vii. *Share common compliance components*

Leading institutions are actively looking for common components of their compliance systems to share across the various regulatory initiatives.

viii. *Link capital and risk to drive performance*

Compliance initiatives are assisting leading institutions to refine their understanding of operational risk so that they are able to better 'price' the risks in activities across their organisations.

ix. *IT systems facilitate a common implementation approach*

Leading practice in financial institutions is moving to the use of better IT systems and technological infrastructure to ensure that the dispersed compliance activities are coordinated, operations are more transparent, monitoring is able to be done on an holistic basis (i.e. for all risk types and compliance requirements), performance can be better measured and overlap and duplication is reduced.

x. *Sound project management practices*

Adopting rigorous project management practice to ensure proper engagement of the relevant stakeholders, version control of documentation, embedding of organisational learning and sound change management, is becoming leading practice among financial institutions which realise they can leverage business benefits from compliance projects.

3. Anti Money Laundering (AML)

Recent estimates suggest that US\$500 billion to \$1 trillion is laundered worldwide annually by drug dealers, arms traffickers, and other criminals. Banks act as gatekeepers for the legitimate financial system and it is only through their vigilance that the system can be protected from providing organized criminals or terrorists with a mechanism for concealing the proceeds of illicit and corrupt activity. As such, they play a crucial role in the prevention, detection, and reporting of money laundering.

KPMG commissioned a Global Anti-Money Laundering (AML) Survey to determine whether the increasing globalization of banking groups and of international regulatory cooperation has resulted in increased consistency in the approach to AML. We also sought to draw out the key questions that we believe bank senior management must consider if they are to help ensure that their banks address the key issues arising from



3.1 Key Questions for Senior Management on AML Issues

- Does your board and senior management consider AML to be a high priority and do they actively demonstrate their commitment to the bank's AML effort?
- Has the senior management team signed off the AML policy, and does it apply on a global basis?
- How does senior management help ensure that the overarching bank AML policies are implemented effectively and in all jurisdictions?
- Have you adopted a risk-based approach to the identification of new customers, and is it sufficiently rigorous in identifying the relevant risks?
- Do you have a formal remediation program in place for our long-standing customers, and if not, how comfortable are we with the potential AML risk of our existing customer base?
- Have you reviewed our transaction monitoring capability and approach, and is it appropriate for our business and customer base?
- Are your procedures for identifying and reporting suspicions suitable, rigorous, and understood by all the relevant staff?
- Have you helped ensure that your AML training is appropriate and sufficient for your staff?
- Have you identified the potential opportunities and benefits from your AML activity for the rest of the business (e.g., credit card and fraud prevention)?
- Do you as an organization have good active relationships with law enforcement, policymakers, and the relevant regulators?

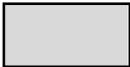
"Effective Know Your Customer ("KYC") procedures embrace routines for proper management oversight, systems and controls, segregation of duties, training and other related policies. The board of directors of the bank should be fully committed to an effective KYC program by establishing appropriate procedures and ensuring their effectiveness."

Paragraph 55 of "Customer Due Diligence for Banks" issued by the Basel Committee, October 2001.

3.2 Suggestions for Improving Existing Monitoring Systems

Respondents of KPMG survey were asked to identify a specific aspect of their current monitoring system they would like to see improved. Comments ranged from improving staff training to agreeing parameters for monitoring with the regulator. Most comments, however, related to installing or enhancing automated systems.

- Better client and transaction profiling, linking the level of estimated activity to actual frequency and number of transactions

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- Pattern recognition of transactions rather than identifying transactions in isolation
 - Broadening of electronic systems used to collect data and better core data in master files, indicating that respondents have experienced the “garbage in, garbage out” syndrome
 - More timely, or even real-time, monitoring rather than analysis of historical data.

3.3 Challenges

The future challenges for banks include how to help ensure that their defenses against money launderers are consistently strong across all their global operations, and how to work more effectively with law enforcement and other banks across the globe to help prevent criminals and terrorists from expanding their empires through the legitimate network. For policymakers, regulators, and law enforcement, future challenges include better coordination of global AML approaches, ensuring critical information interchange can be facilitated, and working better with the industry so that each bank’s contribution is made as effective as possible and is properly recognized when it is effective.

4. BASEL II

The Basel II Capital Accord can be expected to create a variety of regulatory compliance challenges for banks around the globe. The New Accord could trigger a wide range of business implications and management challenges for banks, their non-bank competitors, customers, rating agencies, regulators, and, ultimately, the global capital markets.

The complexity of the New Accord, as well as its interdependencies with International Financial Reporting Standards (IFRS) and local regulation worldwide, makes implementation of Basel II a highly complex project.

The results of KPMG’s 2003/2004 survey, “Eight Questions on Basel”, indicates that many banks are in the early stages of such projects, yet, as they have progressed, their understanding of Basel’s potential benefit has grown.

4.1 Credit risk

Many organisations appear to have realised the significant level of effort required to be compliant with the IRB approaches. Moreover, the uncertainty surrounding regulators’ approach to capital relief is forcing banks to reconsider their decisions to adopt the advanced approaches, with a significant increase in organisations now opting for the Standardised approach.

4.2 Operational risk

The results show that, as firms decide which approach they will adopt, they are showing a stronger preference for the simpler approaches. The data and process challenges associated with the more advanced approaches, combined with doubts about capital relief, are prompting questions



about the value of the effort as well as a recognition of the cost necessary to achieve it.

4.3 Causes for concern

We asked respondents to tell us how strongly they felt certain factors might impact on success of their Basel II programmes.

Almost 60 percent of respondents indicated that the timing of implementation was their greatest concern. Fifty percent also indicated that credit and operational risk (generally) were significant causes of concern.

Nearly half of respondents agreed that Pillar 1 calibration and capital buffer calculations are sizeable concerns, and over half had concerns about the supervisory review process (Pillar 2). It is worth noting that market discipline received a predominantly neutral response (41 percent), with 24 percent strongly disagreeing that this area was of major concern, perhaps indicating that attention has yet to focus on Pillar 3.

4.4 Biggest obstacles

We asked respondents for their views on potential obstacles to successful implementation of their approaches to Basel II.

Overall, and perhaps unsurprisingly, lack of data still appears to be one of the biggest obstacles to compliance. Of those surveyed, a majority thought that the lack of data for the determination of Loss Given Default (LGD) and operational risk losses proved to be big obstacles, each scoring 65 percent. However, only 48 percent thought that Probability of Default (PD) data would be an obstacle, perhaps because this is a more familiar concept for most firms.

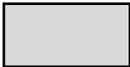
However it is the cost of compliance with Basel II that scored the highest, with 68 percent of respondents agreeing that cost is a major obstacle to successful Basel II implementation.

Other key obstacles include the lack of IT flexibility (62 percent) and lack of internal resources (61 percent).

Concern about all obstacles has increased each year – jumping appreciably from 2002 to 2003 – indicating that, consistent with perceptions of concern overall, the more that organisations learn and progress in applying their chosen approaches, the more obstacles they perceive.

5. Customer Satisfaction: At What Price?

Retail financial services is a difficult business, subject to many pressures. The regulatory environment, risk and capital management, reporting and compliance are all major issues demanding the attention of board and executive alike. On top of this there is still a business to run, with customers to be won or retained, costs to be managed and shareholder value to be created, all in an increasingly dynamic and international environment, where failure on any of these counts



can swiftly lead to the attention of predators, both domestic and international.

Important to the success of a retail financial service organization in this complex environment is the key relationship between the revenue generating client base and the cost of the infrastructure required to service, satisfy and delight them. The cost-income ratio remains one of the most closely watched and targeted numbers in any modern bank.

In their domestic markets banks are restricted to the natural turnover of their client base, capturing their competitors' existing clients with a superior product, channel and/or service, or selling more products to their current customers. Increasing share of wallet is a much used mantra, but the concept is important to increasing revenues and ensuring sustained business growth. Achieving these aims relies on a number of factors.

5.1 Channel

Despite the trend for customers to use multiple channels, the branch is enjoying something of a renaissance. Branch networks are being expanded, existing branches are being refurbished and modernized and opening hours are increasing markedly.

Internet banking was seen by the survey sample as the most important channel for their clients. However, banks' performance in this area is mixed. Delays in launching the service, access problems and security were all raised as significant ongoing issues.

5.2 Product

KPMG survey highlights that having a suitable suite of products is of primary importance. The low interest environment has reduced the banks' ability to differentiate on price alone but two alternative strategies were evident:

- Gaining a better understanding of the customer base and tailoring products accordingly
- Innovation, and perhaps more importantly being seen to innovate.

5.3 Personal service

Softer issues, such as the importance of 'friendly' branch staff and the desire to build a higher-touch trusting relationship, were seen as very important but an area where banks accept that they are under-delivering. This issue is being tackled and frontline staff are being empowered to build these relationships through the provision of better client information and incentivization schemes based on customer service metrics rather than hard sales targets.

5.4 Cost management

The operations function is central to a bank delivering on its customers' expectations. However, they have a further business objective to achieve; namely, generating greater efficiencies and often, cost cutting. Achieving balance between these conflicting pressures is a central tenet for every CEO/ COO.



5.5 People

Banks are still struggling with the optimum balance between operational staffing costs and good quality customer service. Moves to fully automate the telephone banking process have proved unpopular with customers and new technologies have created their own challenges. Outsourcing and offshoring have been successful in helping to meet cost targets but there are examples of this resulting in a decline in service quality.

5.6 Systems and processes

The survey showed that while operations managers were confident they could deliver on their core transaction processes, they faced a number of other challenges. Systems and processes are in need of updating to help improve on the quality and timeliness of information and reduce the number of system failures.

Many large banking organizations have legacy systems that have difficulties interacting with one another. This clearly creates inefficiencies and the survey demonstrated that a significant problem area for operations is the difficulty of creating systems that work across all business units and channels.

5.7 Customer information

Good data management by operations is important to help meet the demands of marketing departments, in terms of generating information about customers and providing the systems to access and manipulate this data. Success in this area has been mixed and the survey revealed examples of where banks had no way of knowing how many customers they had for certain product areas.

6. Corporate Sustainability Report

Reputation is everything. To a large degree, it determines the strength of the bank's brand. It affects your customers, your ability to recruit employees and the way financial markets see you. Today a reputation goes beyond the quality of your products, medium and large companies are now judged on corporate responsibility.

Corporate responsibility is the integration of social, environmental and ethical concerns into a company's values, business strategy and management. Success is measured by both a healthy balance sheet and your ability to effectively respond to stake holders such as investor, employees, customers and the communities in which you operate.

Companies can build shareholder value by creating, implementing and disclosing the right policies. Corporate responsibility creates value through risk management, product innovation and attracting investment capital.

Over the last decade, corporate responsibility has become a mainstream business issue. According to the KPMG International Survey of Corporate Responsibility Reporting 2005, the



majority of the world's largest companies produce reports on their corporate responsibility performance. Almost two thirds of the companies cite economic reasons for doing so, while more than half indicate ethical consideration as well as innovation and learning.

Among the numerous challenges faced by the FS sector today, I have highlighted only a few key issues above. With the right attitude, effective approach and efficient infrastructure these challenges can be converted into opportunities.

“Greatness is not a function of circumstance. Greatness, it turns out, is largely a matter of conscious choice”.

Therefore a conscious, positive, paradigm shift with the unwavering faith that we can and will prevail in the end, regardless of the challenges, and at the same time having the discipline to confront the most brutal facts of our current realities, whatever they might be, would enable our banks to make the leap from “Good to Great”.



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