3C – FORCES SHAPING BANKING FOR CHANGING TIMES

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The rapidly changing banking landscape prompted greater interest in better understanding of many drivers and dynamics of present banking. Banks need to retool their activities to win these challenging drivers. This article will discuss the three revolutionary forces, namely customer, cost and compliance which would contribute immensely towards shaping the banking sector in an increasingly fast moving landscape.

Cost management

In the face of profitability pressures, the growing regulatory compliance cost and revenue growth difficulties, banks need to reshape, by paying more attention to cost cutting and operational improvement. Continuing to keep a sharp eye on cost management and designing more efficient operating models could be critical in this regard.

However, the arbitrary cost reduction based on rationales of sharing the pain equally across the organization is no longer sufficient; instead banks need to take a more strategic approach by viewing cost cutting as a part of the broader efficiency effort. Balancing short term tactical cost reductions with longer term strategic cost initiatives will leave banks much better positioned for future high performance.

Banks today need new operational approaches and encompassing ideas, including how best to deploy technology to make banks more effective. As we are all aware, technology is playing an important role in cutting operating cost to a large extent by realizing scale efficiencies through the process of combining bank officers and the branch network. However, the bank's constant awareness of the cost of deposits or funds would lead to a continual identification of the cost of doing business. A bank also needs to consider IT infrastructure and system maintenance cost which is continually escalating as a part of cost of funds.

There is an important place for consolidation in shaping the banking cost architecture. The search for efficiency gains and higher profitability is therefore an important driver of consolidation. Much of the economies of scale are the results of consolidation. This facilitates banks to reduce their operating costs significantly. It will also contribute to the breadth and convenience of the banking services. Not only consolidation efforts in domestic market but also the cross border merging and acquisition also have an important role to play in shaping the banking sector for the future.

Usually banks have a multi-trade of products and in several cases it was revealed that only 5% of products deliver over 80% of the revenue and an even larger percentage of profits. A bank needs to use BCG techniques or any other method to evaluate products profitability. This comes with a consequent cost in operations and legacy products no longer offered for sale are rarely discontinued. Sometimes banks are compelled to invest in new products merely due to stakeholder pressure which may just add unwanted complexity of the product portfolio without generating profits.

Introducing an awareness culture of cost management is a proven way to reduce cost cutting. In this connection it is necessary to ensure that the integrated cost management is considered a prime objective of the employees, the senior management as well as the boards of directors of banks. Further, the bank could employ a full time Economic Officer to coordinate cost savings activities and monitor performances.

Many banks have taken the strategic decision to outsource many banking activities. Cost savings and efficiency enhancement are the main impetus behind outsourcing. However, the process of outsourcing is also a challenging one as there are many factors to be considered and managed. Outsourcing of banking services can worry the regulator and the government. It may at any moment be a potential threat to the sanctity of the banking industry and tend to transfer risk and it may also affect the industrial peace resulting in trade union action.

The regulator has recognized the potential problems and risk produced by outsourcing. The Banking Act Direction 2 of 2012 clearly prescribes the functions or activities that can be outsourced, the importance of outsourcing policy and monitoring and control of such arrangements. Guidelines also emphasize the Business Continuity Plan (BCP) of the bank and service providers. Further steps have been taken by the regulator towards inclusion of a special clause in software maintenance agreement with outside software companies, requiring them to observe strict secrecy and obtain declaration of persons who perform services in terms of such agreements. While outsourcing can benefit the bank immensely, this will be true if the right activity is selected for outsourcing. Therefore, it is important to understand the tactical use of smart sourcing rather than outsourcing.

The cost of the deposit is the key factor that determines loan pricing and targeted investment income which consequently provides the bank with profit /without a prudent cost of deposit management, the bank could lose its competitiveness. Traditional cost reduction strategies that work in previous banking slowdowns may not suffice today mainly because the existing operating models make it difficult to reduce costs quickly and sustainably.

A bank needs to understand that the cost cutting and efficiency mechanism will vary from bank to bank. In some occasions, tactical cost reductions would have immediate priority and in some other, requires pursuing a broader efficiency focused both on decreasing cost and building capabilities to support growth. Achieving a high performance as a low cost, agile bank will require ongoing vigilance, not just a single effort for change. Going forward, banks must continually revisit cost governance.

Today in Sri Lanka banks are largely operating in an extraordinary benign environment of low interest rates. During such periods banks need to steadily improve their cost-to-income ratio. Under such circumstances banks may continue to have relatively short term earnings but the outlook remains uncertain. The current situation emphasizes how important it is for bankers now to take a strategic view towards managing cost reductions and such initiatives must proceed quickly.

As we are all aware, major portion of our profit share has been the employees. HR must look into areas where our employee roles are aligned to business needs, whether the performance and compensation is aligned.

With the writers' experience, it is found that cost transformation initiative in rapidly identifying major cost reduction opportunity lies within the banks procurement strategy. Most of the times it is not aligned with the overall business strategy and most often never optimize the supplier relationships.

Compliance

Compliance risk has become one of the major risks that banks are facing. The notion of compliance literally means obedience or dutifulness. It has a broad scope; as such it is known to have various interpretations. Compliance generally covers matters such as observing proper standards of market conduct, managing conflicts of interest and treating customers fairly. Professor Arnold Schilder stated that the compliance functions should protect the financial institutions against unlawful behavior and strengthen its ethical consciousness. (While acting in an accountable, responsible manner with the intent of good corporate governance)

The goals of bankers and regulators goals should be compatible with each other in order to create a stable and prosperous financial industry. It is essential that clients are confident of the solidity of financial institutions. Hence every banker should consider whether the current risk control framework in place is still adequate and warrants stability. The Board of Directors of a bank should ensure that adequate controls are in place to oversee the decisions made by the Senior Management and to ensure that the entire organization acts in line with the set objectives and the desired compliance culture. This raises all kind of organizational and managerial questions varying from the amount of autonomy that the business lines should have to issues with regard to control frameworks and reporting lines.

The number of standards and regulations that financial institutions must adhere to is numerous and under such circumstances compliance risk is also increasing. The development of new complex financial products is making compliance functions even more difficult. If a bank is dealing with cross border it further creates complex situations and hence the bank needs to address these compliance challenges in their risk management programs on a global basis.

Awareness cultivation of compliance in employees plays a pivotal role in mitigating compliance risk. It is widely believed that compliance should always be at the forefront of the employee's thinking. Compliance awareness among staff members in many banks are confined to Board level and or senior management level. Even that is vey much doubtful. The Board is responsible for overseeing the management of the bank's compliance risk. However without disclaiming the ultimate responsibilities of the BODs the responsibility for the effective management of the bank's compliance risk resides with the bank's senior management. It is always better to train all employees to create the desired mindset, not only to understand the requirements and regulations but also the "why" of such requirements.

It is also vital to recognize and give appropriate standing, authority and independence to compliance function as emphasized by the regulators. Despite regulatory guidelines, a bank's culture has traditionally devalued compliance efforts while banks do take regulations seriously and try to comply with them which are often regarded as secondary to the real business of banking. Involvement in serious compliance related issues / incidents can lead to reputational damage. In the meantime confidence remains one of the banking sector's cornerstones; a substantial impairment of a bank's reputation could very well lead to collapse.

In modern employee performance appraisal system and employee promotional testing various aspects are being looked into. One area which might be considered by the top management includes compliance related objective arranged along with other dominant commercial objectives.

Sometimes compliance department may not have the means to obtain and analyze data, leaving them to use incomplete data whereas the banks that expect truly to prioritize compliance will accelerate their use of technology so that they can better analyze their own behaviour.

Many instances in bank operations activities especially in product development and marketing are divorced from compliance ownership. Regulatory excellence is a quality component of any financial product and should be treated as such. Product developers prefer to leave some compliance issues to compliance experts most of the time and compliance groups review new products only at the end of the new development process. Shifts in this paradigm is needed both teams to work together from inception to launch stage

The banks today are often encouraged by policy makers to generate new capital and cross border business. Therefore, when dealing with foreign financial institutions such institutions need to stress the importance of timely identification, measurement and assessment of compliance risks. The increasing globalization issues with the corporate governance of such complex institution, the continuously changing understanding of what constitutes sound operational management, changing laws and regulations, combined with a determination with governments and regulators to fight money laundering, terrorist financing and other illegal financial transactions all create complex situations for banks. It is also necessary to pay more attention to the cost of compliance. In all, compliance cost of banks is very substantial.

It is widely understood that importance of compliance needs to grow exponentially and for which, a more structured and coherent approach is necessary by creating the best in class compliance framework integrating all requirements and best practices imposed by regulators, legislators and various international standards setting bodies.

In today's context we say that in marketing, all employees are Marketing Officers while in HR, everyone is an HR Officer. Likewise it is important to understand and treat every employee as a "Compliance Officer". The question that arises from this connotation is that one should continuously ask oneself how I can be sure that my bank is compliant. The above mindset of all categories of employees will facilitate to develop the so called "Best in claims compliance framework" within your bank.

Customer

A bold new environment in the banking industry has already begun to emerge, and it is quickly changing from one that targets generations dominated by a product driven mentality to one where there is clear focus on customer centricity. Banks that ignore this reshaping of the industry risk becoming marginalized and being tossed on the heap of irrelevance. Unarguably, there will be profound changes in the consumer over the next decade. Demographic, social and technological factors will fragment customer needs, tastes and preferences. If banks expect to get more from the revenue spigot, they might figure out which customers to target, which to cut loose, and how to package the products and services customers want, and are willing to pay for that will not be easy. The best banks are becoming future focused, striving to meet the unique needs of a new breed of customers.

Non banks are snatching the market share, fees and other income at an ever-increasing rate. These non-banks include peer to peer lenders that are tapping into retail borrowers, insurance companies, traders, pay day lenders who are reaching the under-banked market.

The banking sector has reached the point where it must decide whether it can turn the customer insight and analytics into a true competitive advantage. By investing in data and analytics across the banking value chain from customer onboarding to complaint resolution banks can gain unique new insights about their customers and products. Similarly, the banks must extract significantly more value from their data assets, both internal and external. The real competitive advantage will go to those players who are able to successfully combine data from all available sources to develop a better understanding of their customer needs, refine customer segmentation approaches, design more compelling value propositions and identify impactful differentiation strategies. All of these in turn, will help banks to improve their cross selling and drive revenue growth. While banks realize that more can be done to capture value form existing internal data, it is a challenging task that is easier said than done.

In the face of these challenges, banks should change tack to fully exploit the rich data they already are in possession. This will require that customer insight and analytics team will have to become much better at demonstrating the value they add to the business, while developing a highly honed understanding of the business itself.

Also, the banks need to revisit their existing methodology of analyses of customers and concentrate more on new ways of approaching customers including ethnographic research mining, social media and new mobile channels etc. Meanwhile more effective focus on growing revenue using a variety of strategies including new fees and business will lead to bolstering cross selling efforts.

Under the loan drive by all banks, in the present context of combat competition scenario there may be the possibility of granting loans to subprime customers. We have had experiences in the pawning market 2 to 3 years back. Customers are bombarded with heavy advertisements and all banks are pivotal on pawning business. Under such circumstances banks are made cautious about product innovation and promotion. These pressures are forcing banks to design more competitive product offerings with pricing plans that appease both customers and regulators. In spite of these constraints banks can reinvigorate their revenue growth strategies thorough a more thoughtful product mix and more refined customer segmentation approach.

Conclusion

While banks are looking forward for a much more sophisticated view of their cost structure and the key drivers of that and to compare with “best in class” competitors, they should alternatively focus on growing revenue using a variety of strategies, including new fees, repricing of premium prices, bolstering cross selling efforts and greater focus on fee based business such as wealth management.

It is true that many of the bankers expect the importance of branch banking to diminish significantly as customers migrate to digital channels. However, people still rule supreme and many products still require customers to transact through a Branch. Despite that the mobile and wireless market has been one of the fastest growing markets in the world and in the country, mobile banking penetration accounts very minimal, Regulatory issues may hamper such progress.

Regulatory forces continue to shape the competitive dynamics of the industry. Compliance is pushing banks to rethink the business they want to be in and the customers they serve. Banks that are able to institutionalize compliance in an effective and efficient manner could create competitive advantages allowing them to best pursue their growth agenda. As the laws, regulations and standards are continuously changing in this manner, compliance becomes a moving target for banks and compliance today but no longer so tomorrow. Banks that get this right will achieve dramatic results. Every bank needs to focus on the future landscape and the true success in next generation banking will go to those who are prepared for 3 C forces that are shaping the industry. This paper has attempted to highlight all those forces and outline the key ingredients for success.