Transformation in the banking sector

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Banking is changing across multiple fronts

The banking sector remains an industry in flux. The days of leverage-inflated, 20 percent returns on equity are a thing of the past. Management is now judged by its shareholders as performing well if it is able to deliver certain benchmarks in performance related to return on capital, equity, cost as well as net income and profit that would be considered paltry by previous standards.

The concern though for banks is that even as the benchmark for their performance has been lowered, this is still often proving difficult to achieve due to increased local and global regulatory costs, sluggish economic growth and, perhaps most importantly, market competition and emerging disruptors to the banking ecosystem. Whereas previously most banks would have relied upon reducing headcount, offshoring work or raising fresh equity to navigate a profitable path, this will no longer suffice. Balancing these competing priorities requires a transformational approach to practically all aspects of the banking sector.

Multiple disruptive forces are affecting the sector

Banks will need to make transformative changes during a period of great uncertainty. The pace of new regulations shows few signs of abating, which is putting pressure on capital and in some instances reducing revenue growth altogether by limiting certain activities, for example the Volcker rules on proprietary trading or regulatory attention on alternative liquidity pools and protection for investors as relates to best execution/pricing in Asia. At the same time, the threat of disintermediation from a whole host of well-funded technology firms, not to mention perennially low interest rates, is putting pressure on banks' margins.

Some specific examples of changes confronting the banking sector at the moment include:

- the effect of new regulations not just in Hong Kong but at the regional and global level as well. This requires banks to develop robust governance mechanisms as well as utility-like data and testing infrastructures to deal with new and emerging regulatory and reporting obligations. Examples include Consolidated Audit Trail in the US, the Markets in Financial Instruments Directive (MiFD II) in the EU and Non-Financial reporting obligations in Asia;

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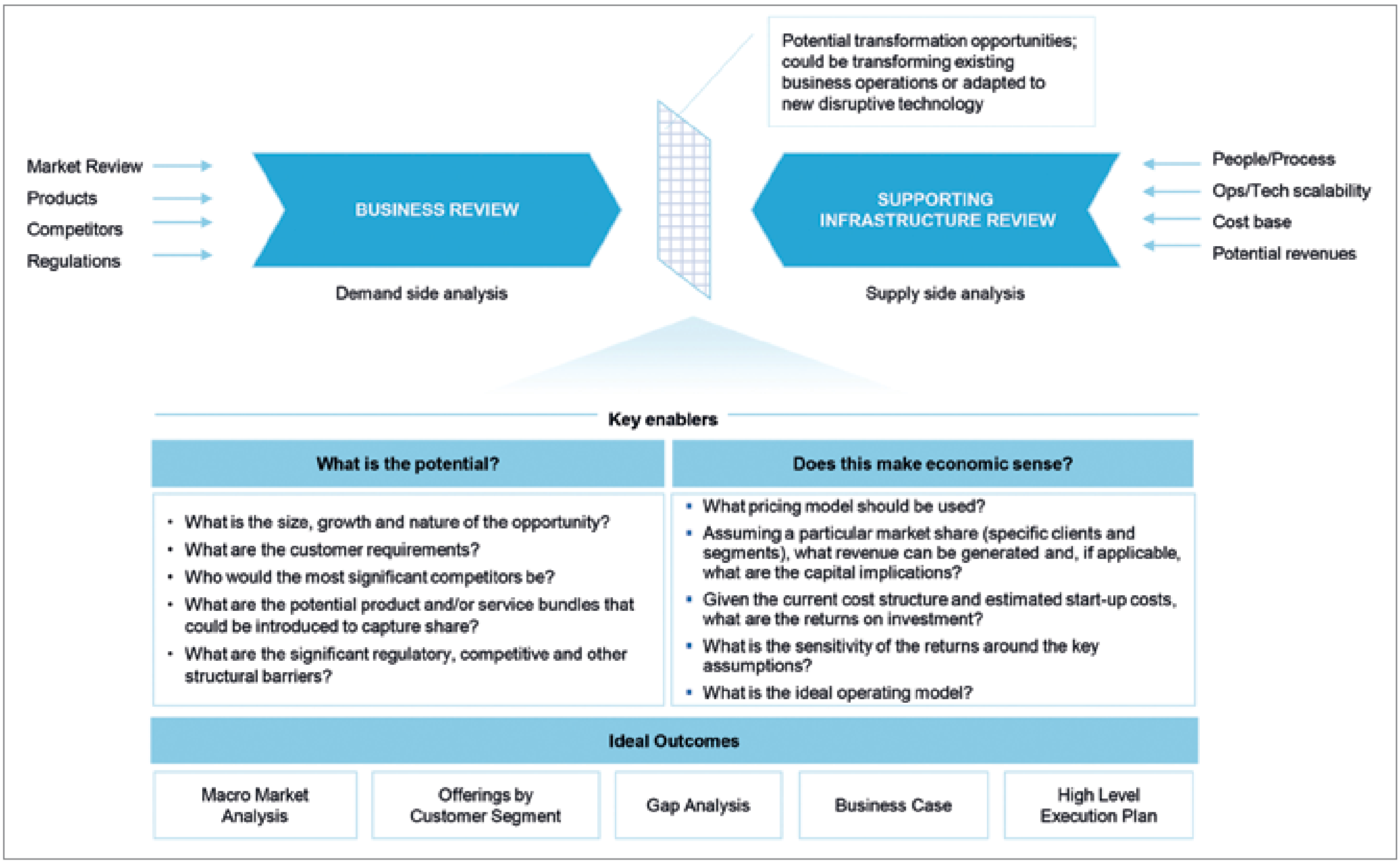
- the emergence of new derivatives booking structures given the increase in cross-border regulations in both the US and the EU. Hong Kong stands to benefit potentially from these developments as banks have been stepping up their efforts to establish regional booking hubs in Asia in the last few years;
- the referendum in the UK on the country's membership of the EU. This has created some uncertainty, particularly with regards to passporting and has led many banks to consider moving their European headquarters from London. Some banks with strong ties to Asia may even look to Hong Kong as an alternative for additional capital funding as a booking centre;
- the increase in the number of Fintech start-ups. Hong Kong has established itself as a regional hub with many financial services companies responding by seeking out partnerships with these new firms. A large Chinese insurer recently joined the R3 consortium along with a few US based investment banks, which seeks to pioneer the use of blockchain technology in the industry;
- the number of companies moving beyond their core areas of expertise, referred by us as 'competitive convergence'. Examples include asset managers investing in robo-advisor technology and selling this robo-driven investment advice directly to wealth managers/advisors and custodians expanding into new services like execution to custody and collateral management, especially in fragmented markets like Asia.[1]

Transformation is a difficult process

Balancing these multifaceted priorities requires a thorough transformational approach that will impact virtually all areas of the organisation. This requires the input not just from business stakeholders and leaders, but also from other areas of the organisation including operations, technology, risk, legal, human resources and communications.

Leaders that want to affect change should start with a proper assessment of the current condition of the market, competitive landscape and the organisation and then follow up with a strategy and business case outlining any risk considerations, the investment required and a clear roadmap for achieving their end goals, which should include change management and communication plans.

[1] Aite Group, *Emerging Players in Digital Wealth Management: Competing for the Everyman Investor*, http://aitegroup.com/report/emerging-players-digital-wealth-management-competing-everyman-investor.



Although many Hong Kong banks have started to embrace new operating model constructs, these initiatives have been largely tactical and 'cost' focused in nature, which has led to the accumulation of several siloed models at once, creating a drag on business agility and future growth.

In our experience, those organisations whose transformation efforts falls short of the desired outcomes tend to come unstuck for one of the following reasons:

- technology expenditure, both in relation to the transformational agenda and the back office systems required to support change, is underestimated;
- management does not appreciate the scale involved in creating segregated operations teams for client onboarding, legal, regulatory, etc;
- management does not consider the need to incorporate system scalability into its transformation plans and the potential for business variability;
- regulatory responsibilities, in particular reporting requirements, are not evaluated and properly incorporated into the new business model;
- to the extent that capital considerations are in play, the requirements are underestimated at the outset of the presentation of the business case.

The impact of transformation on business operations

In addition, the impact of any transformational exercise on operations is typically the last component to be considered when developing a business case. Based on our experience, however, a number of critical components should be considered and thoroughly analysed before embarking on any transformational programme:

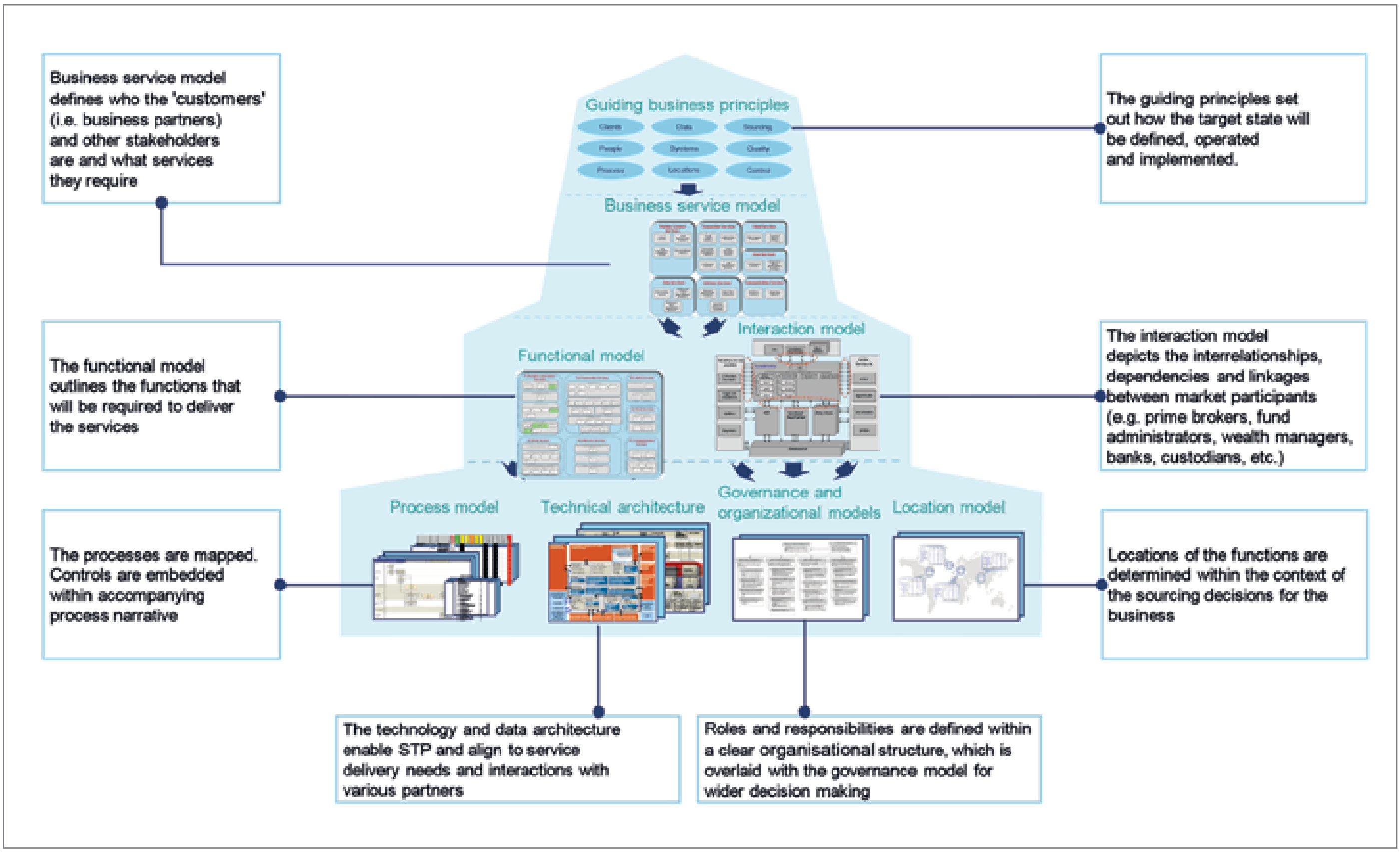
Governance and ownership	Regulatory	Technology and operations
• legal structure and location, • revenue and profit sharing model, • governance structure including board and senior management, • mandates, • strategic plans, • principles, • conformance, • tax and accounting.	• discussions with regulators to gain their acceptance of concept, structure, and governance model, • understand and address their concerns, • resolve joint regulatory responsibilities/liabilities, • resolve protocol for regulatory exams, • gain approval/concurrence from internal risk and compliance, • standardise AML policies and methodologies.	• design and development of operating model, • business, data and technical architectures, • operating principles, standards and procedures.

Perhaps the most critical component business leaders need to consider when assessing the impact of transformation on an organisation's operational capability is whether the operating model is sufficiently flexible to be scaled up and scaled down in line with business needs. Although many Hong Kong banks have started to embrace new operating model constructs, these initiatives have been largely tactical and 'cost' focused in nature, which has led to the accumulation of several siloed models at once, creating a drag on business agility and future growth.

Above all, the target operating model will need to encompass the following principles:

- it should be highly automated, low cost, robust and easily scalable depending on the business needs at the time;
- it should combine different business lines (e.g. investment banking, private banking, etc), thereby leveraging economies of scale;
- product and client needs should be separated along developed market vs. developing market lines rather than using old geographic boundaries;
- generic and high margin products should be separated in order to leverage cost efficiency for generic products and to improve margins for bespoke products;
- joint ventures with technology firms or other third parties should be considered on a case-by-case basis.

When seeking to develop an action plan for the operating model, the following components should form the basis of any discussions:



Engaging the organisation on any transformation agenda is critical

Success in managing transformational change comes down to having a clear understanding of the business imperatives and operational requirements and then shifting the organisation's focus. This starts ultimately with the CEO's vision, although this needs to be communicated properly to the workforce in order to ensure organisational buy-in. In order to achieve the support of its employees and its stakeholders, leaders need to solicit regular feedback from their staff and also to coordinate with HR in order to provide incentives that coincide with the organisation's strategic objectives and help to transform workplace culture.

Transformation also necessitates the up-skilling of existing staff. KPMG's recent Global CEO survey found that 99 percent of CEOs were taking action to develop existing or future talent. In line with these findings, over 50 percent of CEOs reported some level of skills gap emerging as their business transforms.[2] In the coming decade, technology, in particular, is expected to revolutionise the banking workforce. While this may or may not lead to a reduction in headcount, what is beyond doubt is that the roles of those in the industry will be fundamentally different with staff performance enhanced by supporting technology. As a result, transformation of talent is just as important to building a viable, successful banking franchise as transforming products, processes and supporting infrastructure.

The era of once-and-done transformation is over

The confluence of a number of major trends affecting the banking industry has pushed transformation to the top of the agenda of today's business leaders. The pace of technological change continues to hasten, while the continued uncertainty over the health of the global economy, the threat emerging from new regulatory developments and other disruptive forces have rendered the era of once-and-done transformation a thing of the past.

Today's banks have to remain nimble in response to these market forces if they are to survive and prosper. While it is true that organisations need to be careful in striking a balance between overhauling existing structures and processes on the one hand and ensuring the day-to-day smooth operation of the organisation on the other hand, the biggest threat to banks going forward will be complacency. The stakes are too high for many banks to continue to tread water. Investors have made clear that they will not tolerate single digit returns on equity in the long run and a whole host of well-funded technology firms are fast disrupting a lot of services previously considered exclusively the preserve of established financial services firms. Given this backdrop, nothing short of a transformational approach will do.

[2] KPMG, *2016 Global CEO Outlook Survey*, https://home.kpmg.com/xx/en/home/insights/2015/07/ceo-outlook-survey.html.

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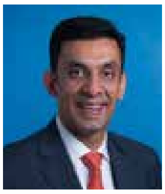

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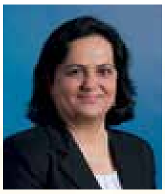

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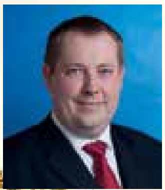

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