



cutting through complexity

# UK banks performance benchmarking report

Half year results 2014

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# INTRODUCTION /

RICHARD MCCARTHY  
Head of Banking



The vital next step for UK banking is a conceptual change. On the West Coast of the US, innovations such as peer-to-peer (P2P) lending are flourishing. Young firms and players new to the sector are bringing fresh, exciting and agile solutions to core banking challenges. New entrants take cloud computing as their starting point. They're building business models from scratch without the burden of legacy processes or infrastructure.

That's not to say the UK banking sector isn't also in a period of renewal. Innovation aside, there is acceptance of change in a bid to redefine a "new normal." This is evident in the industry's leaders' fresh sense of purpose to recreate their organisations using new technologies and improved analytics.

This positivity is appropriate – even after a long period of remediation; despite the fact that huge risks remain; and that there are major obstacles to overcome. We see three broad themes to this renewal.

## **A new embedded culture and approach to doing business**

Public perception and trust in banks remains at a low ebb. The core challenge facing bank leadership teams is the need to create ingrained cultures, systems and behaviours that will lead to great outcomes for customers and society as a whole. The tone at the top is already clear and true. Now, the challenge is to embed this all the way through the organisation.

## **A transformed delivery capability**

We don't see appetite for innovation and change as the core challenges. The big issues in fact, are the ability to overturn inappropriate use of data, inflexible systems, and replace ineffective or overbearing controls. These will allow banks to set out and implement strategic change in a timely way for regulators, customers, employees and shareholders.

## **Modern and flexible technologies underpinning growth**

Digital disruption is a reality in most markets and the financial sector isn't immune from this fundamental force. We see widespread recognition of the need for more modern, flexible technologies. These will help banks develop innovative products and alternative business models more quickly as well as provide more efficient controls and risk management.

This report offers our points of view on these themes. We can already see banks making a clear and public commitment in many of these areas and these are highlighted. Those that adopt clear strategies in all of them will be particularly well placed.

“  
After seven years of crisis,  
the banking sector can finally  
shift focus from cleaning up the  
past and start to make steps  
towards delivering sustainable  
growth and profitability.”

## AT A GLANCE<sup>1</sup>

PAMELA MCINTYRE  
Head of Banking Audit



The half year benchmarks tell us banks have turned a corner. The numbers on profitability, remediation costs, return on equity and lending are all moving in a positive direction, albeit slowly after a long period of adverse trend.

### The UK banks continued their return to profitability

All the five UK banks recorded profits in the first half of 2014. Cumulatively, they made £15.2bn, which is approximately 8% lower than the corresponding period in 2013. Whilst this is still a far cry from the pre-crisis years, importantly, all banks improved on their profitability from when compared to the second half of 2013. Some of the key features of the results are:

- ▶ Total income continues to be depressed, particularly trading revenue which is down by 52%;
- ▶ Conduct related costs since 2011 have now reached £31bn - more than twice the H1 2014 earnings;
- ▶ Loan impairments continue to steadily fall but the total non-performing loan portfolio is still almost thrice the pre-crisis levels;
- ▶ Loans to banks and customers stood at £2,335bn, which has ticked up marginally half on half, but is still 14% lower than what it was at the end of 2009;
- ▶ The demand for capital continues to rise, and at the end of H1 2014, Core Tier 1 Capital was £67bn higher compared to 2009, but supporting an asset base which is £852bn or 14% less than 2009.

	Barclays		RBS		Lloyds		HSBC		SCB	
	2014	2013	2014	2013	2014	2013	2014	2013	2014	2013
Statutory profit/(loss) before tax (£ million)	2,501	1,677	2,652	1,374	863	2,134	7,238	9,112	1,908	2,153
Total income <sup>2</sup> (£ million)	13,624	15,425	10,160	11,272	14,034	22,072	22,423	25,924	5,428	6,390
Net interest margin (basis points)	406	400	217	197	240 <sup>3</sup>	201 <sup>4</sup>	195	217	210	220
Cost to income ratio	73.0%	78.0%	64.0%	65.0%	50.5% <sup>5</sup>	52.7% <sup>6</sup>	58.6%	53.5%	54.7%	51.4%
Impairment charge (statutory) (£ million)	1,086	1,631	269	2,150	641	1,683	1,080	2,018	496	473
Return on equity	4.2%	2.6%	7.0%	Negative <sup>7</sup>	- <sup>8</sup>	- <sup>9</sup>	10.7%	12.0%	10.4%	13.3%
Impaired loans to loans and advances to customers	2.6%	2.8%	8.3%	9.4%	5.0%	6.3%	3.2%	3.6%	2.5%	2.3%
Impairment cover	54.0%	54.6%	66.0%	64.0%	52.3%	48.7%	41.2%	41.6%	53.0%	56.0%
Redress, regulatory and litigation costs (£ million)	900	2,504	250	620	1,100	575	175	643	-	-
Total assets (£ million)	1,314,899	1,343,628	1,011,108	1,027,878	843,940	847,030	1,615,230	1,619,887	404,828	394,134
Net assets (£ million)	65,025	63,949	60,963	59,215	45,878	39,336	116,568	115,494	28,486	27,505
Loans and Advances to Banks <sup>10</sup> (£ million)	43,448	39,422	28,904	27,555	21,589	25,365	74,724	72,796	53,626	50,757
Loans and Advances to Customers <sup>11</sup> (£ million)	442,549	434,237	385,554	390,825	491,345	495,281	614,301	601,602	178,946	176,285
Deposits to customers (£ million)	443,638	431,998	401,226	414,396	445,091	441,311	830,438	825,491	229,077	231,078
Core Tier 1 ratio (%)	9.9%	9.1%	10.1%	8.6%	11.1%	10.3%	11.3%	10.9%	10.7%	10.9%
RWAs (£ billions)	411	442	392	429	257	273	732	663	206	195

#### Footnotes:

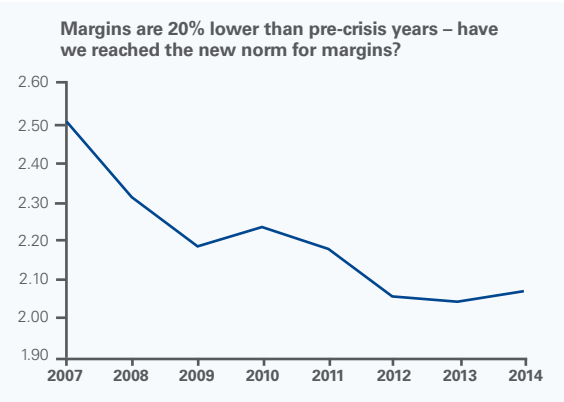
1. Income statement comparative figures are for the half year period ended 30 June whereas the balance sheet comparative figures are as at 31 December
2. Total income is presented gross of insurance claim
3. The figure is presented based on underlying basis
4. The figure is presented based on underlying basis

5. The figure is presented based on underlying basis
6. The figure is presented based on underlying basis
7. H1 2013 reported 7.4%. Full year negative
8. Lloyds did not report return on equity
9. Lloyds did not report return on equity
10. Loans and Advances exclude reverse repo
11. Loans and Advances exclude reverse repo

Trading revenue drags down banking revenue

The five banks recorded total income of £65.7bn, 19% lower than the corresponding period in 2013. One of the main drags was trading income, which declined by £11.8bn or 52% offsetting revenue growth in more traditional banking products. Trading income has been mainly impacted by surplus liquidity in the market, lower volatilities and much more intense regional competition.

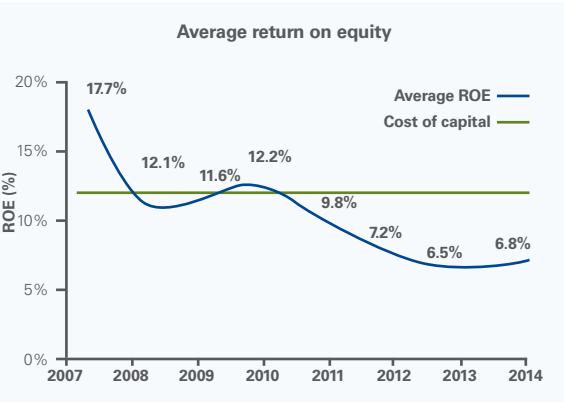
The increase in net interest income was largely due to increased volumes as margins remain under pressure. Margin contraction has been a consistent feature since 2007 and is now approximately 20%, or 50bp lower than 2007. Amongst other factors, the downward trend is primarily a feature of the prolonged low interest rate environment and fewer structured products that attracted higher margins in the past. Encouragingly, this declining trend appears to have now stabilised slightly over the last two years and is in fact starting to show a small uptick, however we seemed to have reached the new norm for margins.



Average return on equity sees a slight rise

Since 2009, the average return on equity across all banks has decreased from 11.6% to 6.8% and is a long way off from the high teens of the pre-crisis years. However, interestingly, if we took away the impact of the huge cost of customer remediation since 2011 the return on equity of the UK banks would have been significantly higher over the same period. Lower margins, massive conduct related costs and much higher capital requirements have all contributed to a much lower return on equity for the sector for the last few years.

The slight increase in 2014 is primarily driven by lower credit impairments and higher income compared to H2 2013. Future model changes will continue to add more pressure on capital through increased risk weighted assets. Although the trend in the first half of 2014 is encouraging in terms of the rehabilitation of the banking sector, the continued low returns will challenge the ability of the banks to make the required significant investments for the future.



Source: — Based on the average of published RoEs  
— KPMG analysis

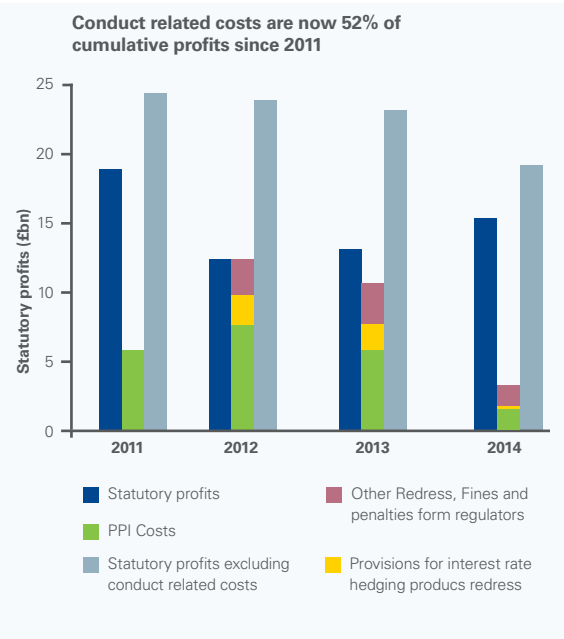
Remediation charges continue to squash profitability

All banks have been heavily focused on cost control over the last few years and we have seen rationalisation of operations and headcount reductions. However, the cost of conduct related issues is hindering the ability of management to manage costs and between 2009 and H1 2014, the average operating expenses across the five banks have actually increased by 1%.

The total cumulative cost of customer remediation, conduct failings and fines for the five banks is now £30.9bn since 2011 – more than twice their H1 2014 profits. More remarkably, the cost of customer remediation and other conduct related issues now represents 52% of the cumulative profits of the UK banks since 2011. However, one positive trend is that the current half year charges are lower than the earlier years.

Cumulatively, in the first half, the five banks provided an additional £1.8bn for payment protection insurance (PPI) and £150m for interest rate hedging products (IRHP) as past conduct issues continue to bite. The majority of the PPI charges during H1 2014 was driven by Barclays (£900m) and Lloyds (£600m) with RBS contributing the majority of the IRHP increase (£100m).

The conduct agenda remains one of the single largest worries for banks as remediation costs and fines continue to drag the UK banking results for the last few years and this trend is expected to continue. There continues to be a range of further potential conduct issues that are under investigation, including alternative trading systems, alleged foreign exchange markets manipulation, CDS markets and alleged gold and silver exchange manipulation.



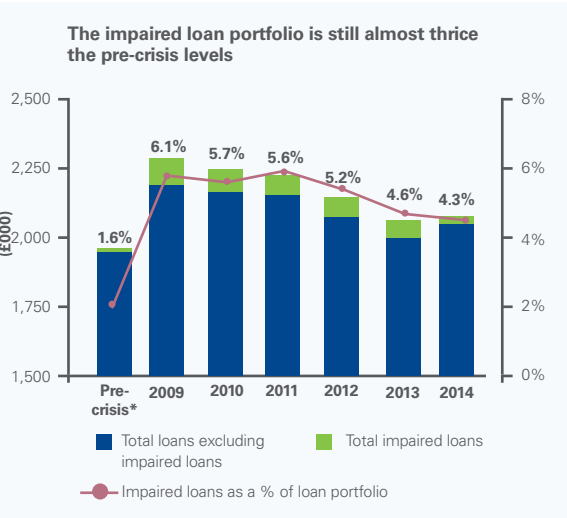


**Impairment charges continue to fall but the impaired loan portfolio is still almost thrice the pre-crisis years**

Overall impairment charges declined by 55% to £3.6bn compared to £8.0bn at H1 2013 with the UK banks benefiting from improvements in credit conditions and more focused risk management. Compared to 2009 the comparison is even starker with impairment charges down by 88% from £29bn in H1 2009.

RBS experienced the largest decline year on year seeing impairment charges decline 87%.

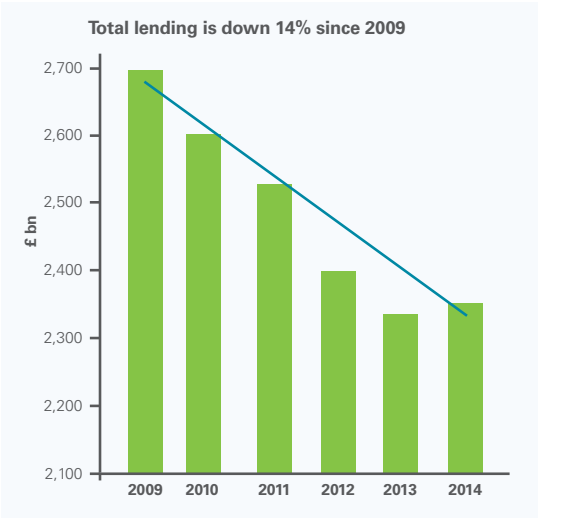
While the impairment reduction story is good and is showing declining trends, average impaired loans as a percentage of loans and advances to customers remain high at 4.3% of the total loan book, compared to a pre-crisis level of 1.6% in 2007, signalling the uncertainty of the markets in which we operate.



**Lending is down 14% since 2009**

The other area of worry for the sector and indeed the economy is the lending volumes. Overall, loans and advances for the five banks stands at £2,335bn, £364.7bn or 14% lower than 2009. Whilst it is showing a small uptick since last year, it still has a long way to go.

Lending to customers accounts for the majority of the decrease since 2009 (£309.0bn), though it has improved slightly since the end of 2013. Since 2009, the overall decrease in loans and advances has been driven primarily by just two banks, RBS and Lloyds, which have seen decreases of £329.6bn and £149.4bn respectively, as a result of run-off and the disposal of non-core assets as they overhaul their business models. Since 2013, Barclays, HSBC and SCB have seen an increase in their loans and advances portfolio; for both HSBC and SCB this is primarily due to growth in Asia, and for Barclays this is due to an increase in settlement balances and growth in the Personal and Corporate Banking sector as a result of increased UK mortgage lending.

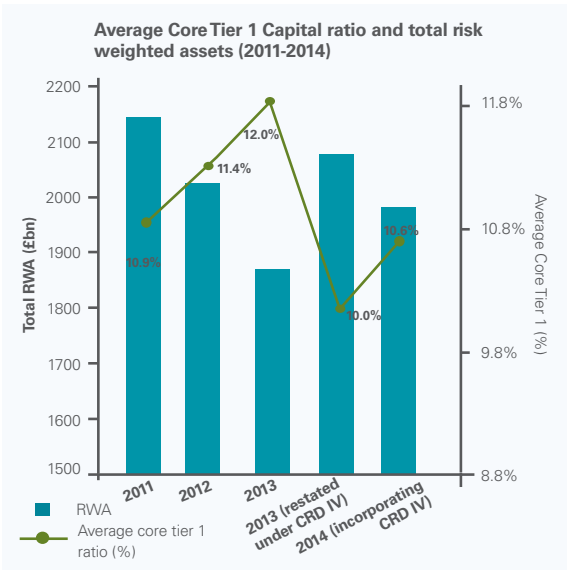


**Core Tier 1 capital increased by £67bn since 2009 for an asset base which is £852bn less**

At £5.2tn, total assets have remained stable since the year end, but have declined by £852bn since 2009, a decrease of 14%. While the decline primarily relates to reduced derivative exposures, lending and trading strategies, including the asset mix and risk appetite, have also undergone a paradigm shift as indicated by the declining RWA position. The increases to Core Tier 1 Capital are in response the evolving prudential regulations, primarily CRD IV and model changes. Banks have adopted a two pronged strategy to meet the challenging targets. Traditional capital raising and profit retention is being increasingly complemented by targeted de-risking and reduction of RWA.

From 1 January 2014, banks moved from calculating their Core Tier 1 ratio and risk-weighted assets under Basel II to CRD IV, with all banks showing a reduction in their Core Tier 1 ratio when compared to 2013. However, when the 2013 balances are restated under CRD IV, all banks showed an increase from 2013, with the exception of SCB which shows a decrease of 0.4% due in part to the timing of dividend payments.

As we've highlighted, getting returns up remains hard due to low interest rates and higher capital. However there is light at the end of the tunnel on remediation costs and impairment charges as these continue to fall. Provided the economy continues to improve banks are entering calmer waters where they can start to build the bank for the future.



## STRONG CULTURE AND ETHICS

KLAUS WOESTE



Banking is risk. But in the rush to atone for past sins, regulators and banks have lost sight of this fundamental truth. Klaus Woeste explains the role of ethics in establishing a 'healthy', balanced risk culture.

It's not surprising that risk, culture and ethics have been pivotal discussion points in banking for some years. Overly risky and unethical behaviour has defined public, political and regulatory perceptions of the industry since the financial crisis broke. If banks are to move out of the remediation phase into sustainable growth, they must help shift this impression by demonstrating that their culture has changed.

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**Changing an internal culture is always difficult, but it is especially so when the old culture was successful for many years.**  
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Over the past few years, the onus has been on the industry

to fix its ethical reputation and to demonstrate that it has developed a more mature approach to risk. Regulation was the impetus – and this shouldn't be the case. Society demands a level-headed and trustworthy banking sector and the banks have clearly demonstrated a desire to look inward as an important first step in achieving that, regardless of regulatory pressures.

Changing an internal culture is always difficult, but it is especially so when the old culture appeared so successful for many years. At all levels within the banks, habits and instincts formed over many years remain deeply rooted.

But much of the groundwork has been done. Banks have started to bed-in new approaches to an ethical culture and have removed incentives that encourage the attitudes that are harmful over the long-term. Ultimately doing the right thing for customers ought to be a simple and compelling set of behaviours that also make good commercial sense for the bank. The opportunities we see are as follows:

### **A renewed employee-value proposition**

Organisational values are tied to performance metrics and scorecards, but banks need to create compelling employee value propositions that are intrinsically linked to positive customer outcomes. The value proposition needs to be a psychological contract between each employee and the bank that motivates appropriate customer interactions.

### **Simplify employee messaging**

Employees risk being lost in an avalanche of new regulations and internal controls stacked on top of each other, creating duplication and complexity. As a result, they are not clear on what is required of them and less confident in applying sensible and consistent approaches to risk. Staff need a clear understanding of what they can and cannot say and do to all types of customers at each stage of the customer experience. But we must prevent the pendulum swinging between overcautious and over-exuberant behaviour. Nuanced and well-judged communications on ethics and risk appetite are crucial.

### **Remove the broad-brush approach to training and development**

One training programme just won't do for all employees. Banks can use employee data to understand individual requirements and motivations for training. An understanding of the best ways to encourage desired behaviour from all staff is fundamental to building a robust training programme that is appropriate to all employee types.

### **Mend the cultural fault-line between upper and middle management**

There is disenfranchisement in mid-management levels in many banks, as they struggle to fuse new cultural requirements with performance measures set on strong financial targets. Addressing this cultural fault-line should create an environment where the good intentions of senior leaders are reflected in the behaviour of everyone within the bank. Appropriate risks must be embraced, not feared.

# GREAT CUSTOMER OUTCOMES



TIM HOWARTH

A more sustainable approach to banking should lead to better customer outcomes. But, says Tim Howarth, finding the right balance between bank profitability, risk appetite and customer protection will demand clarity across the bank, from boardroom to branch.

In the years around the financial crisis, there had been a dramatic loss of balance between the interests of customers and those of the banks. In the immediate aftermath, banks may have talked about putting customers first, but that had rarely tallied with the observable experience of customers themselves. Legacy issues from the financial crisis continue to muddy the picture.

Today, most banks (especially, but not exclusively, in the retail space) have recommitted to a customer-first policy. RBS, for example, has announced a refreshed strategic direction with the ambition of “building a bank that earns its customers’ trust by serving them better than any other bank.” Lloyds states that it has “one strategy for delivering sustainable success – being the best bank for customers.”

Widespread adoption of metrics such as net promoter scores show the banks’ keenness to measure positive customer sentiment. This is a positive step, but they cannot underestimate the importance of these opinions. According to YouGov’s Sixth Sense Survey April

2012, the second biggest driver of trust is a good opinion given by family and friends. In a world of pervasive social media, each and every customer interaction can drive positive or negative outcomes, which are shared quickly.

Backed by research conducted for our Customer Experience Barometer in May this year, there are four core areas banks should consider as they start to manage these customer challenges, and the associated internal and external changes they create.

**Better customer segmentation**  
Successful retailers already know that with the right systems, data management tools and customer interactions, it is possible to develop a deeper understanding of what consumers need. Customers are getting used to companies that tailor products to their specific requirements. So naturally they assume that banks, too, ‘know about me’ and get frustrated when products or services fail to deliver as expected. The banking sector’s ability to satisfy these expectations rests on the quality

and accessibility of customer information they have about their customers; and the systems they have in place to use this data. Banks need to work hard to identify the key areas of change in order to successfully segment products, spotlight potential customer service issues and address them before they become complaints – or identify what might turn out to be wider systemic risks.

**Simpler to understand products**  
Good customer outcomes are easier to deliver when banks are more discerning in their innovations. Product development has to focus on the requirements of the customer rather than the bank. The spotlight needs to shift to identifying real customer needs and bringing suitable and sustainable offerings to the market. Two driving factors for customers are value for money (through fair and appropriate fees and charges); and having services and products that are easy to understand.

## Investing in the customer experience

There are significant benefits to a move away from treating customers as a series of complex transactions, and instead looking at the overall, end-to-end relationship the bank wants to build with them. It’s the richness and closeness of that relationship that ultimately defines and secures better customer experiences. Better, more consistent customer service matters: there is a direct link between the level of complaints and referrals or net promoter scores, for example.

Banks focused on the right areas – making it easy for customers to raise concerns; dealing with issues promptly; and thinking about the relationship rather than a product – should see real gains.

## Setting a clear direction on what “good” looks like

What banks know – but the media and public often forget – is that frontline staff almost never set out to do the wrong thing. Problems have arisen when the notion of what a good customer outcome looks like is mistranslated at some stage in the

internal communications process. Managers with tough financial targets, for example, might have interpreted the priorities of senior staff incorrectly and inappropriate behaviours became embedded into processes for customer-facing staff. As discussed on page 3, clear staff messaging and tailored training can help reconnect shareholder value with customer value. As our Customer Barometer shows, banks will drive better outcomes through honesty, putting the customer first, getting it right first time and following through on promises.

## Ranking of most important attributes versus performance of attributes

	Key	Importance	Performance
1	Value for money (i.e. fair and appropriate fees and charges)	74%	49%
2	Staff who are honest and tell the truth	74%	56%
3	Staff who consistently follow through on their promises	70%	51%
4	Getting things right the first time	69%	53%
5	A company that puts the consumer first	69%	46%
6	Quality of advice and service offered	69%	52%
7	Speed when resolving a complaint/resolving a query	68%	51%
8	A company I know will deliver	68%	50%
9	Trust that the brand delivers on its promises	68%	48%
10	Ease of getting issues/queries/complaints resolved	67%	50%

Source: KPMG Customer Experience Barometer, May 2014



# FAIRER AND MORE EFFICIENT MARKETS



PETER ROTHWELL

Many of the pre-crisis problems in banking were rooted in opaque practices designed to maximise profits. Peter Rothwell says successful banks will reverse this approach, with transparent markets and efficient transactions a source of competitive advantage.

The banking sector has a complicated relationship with the concepts of fairness and efficiency. Bluntly, banks made more money when markets weren't efficient or when complex products were hard to understand. But there has been a reassessment of conduct and reputational risk attached to those kinds of transactions, with many UK banks making a public commitment to move away from opaque markets.

A spate of recent scandals has had a significant impact on the industry leading to a fundamental shift and reassessment of the way in which banks view conduct and reputational risk. One response has been for banks to withdraw from activities in sensitive sectors, such as trading of agricultural commodities, where the risk-adjusted rate of return is no longer acceptable. However, this creates a dilemma in terms of market efficiency. While getting out of markets and products now seen as non-core makes perfect sense for many banks, market users may suffer from higher price volatility due to a removal of market liquidity.

This liquidity will also be reduced due to the inconsistent application of structural and regulatory reform which will distort and undermine the concept of a global product booking model. Banks will instead focus on those geographic markets where they can extract a comparative advantage in price and profitability with a detrimental effect on end users and consumers.

In addition, the determination of regulators to enhance financial and market stability is increasingly driving simplification and standardisation of products. There's a much greater emphasis now on exchange traded products rather than over-the-counter transactions, for example. While this increases transparency and, therefore, fairness, there is potentially a price to pay in respect of choice. Previously, customers could bespoke over-the-counter products to meet their precise requirements at the cost of transparency. Now, it may well be that the cost of transparency is a lack of choice – and hedges may become more ineffective.

In this context we see the following as core focus areas:

## Demonstrate transparency and underlying value

In transparent markets, extra profit requires higher transaction volumes, supported by a sustainable low-cost operating model. To successfully grow volumes, banks will need to focus on developing customer relationships and adding value. A key element of this is greater transparency in respect of the revenue being retained by the bank as a result of the customer's activities. The model must become one of enriching the overall customer experience and outcome, rather than maximising profitability from each transaction.

## Critically assess front to back activity

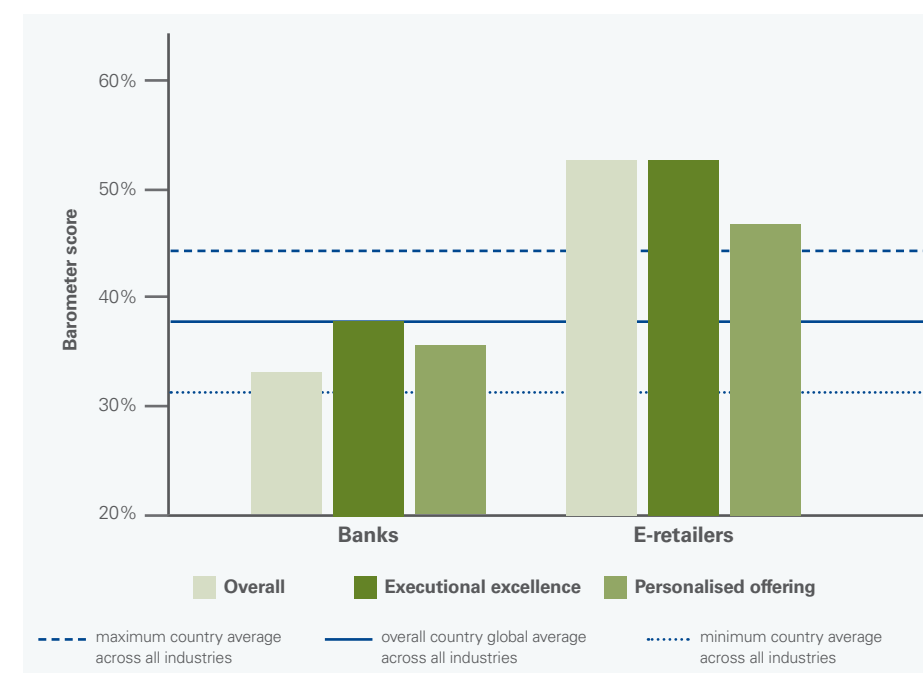
Better use of technology in a simplified architectural environment is a critical enabler in respect of banks seeking acceptable returns in the new commercial and regulatory environment. However, banks must go further

with their operating models. They need to critically assess front to back activities and processes that support their businesses in order to identify areas that could be consolidated – in a shared service, off-shored to a lower-cost location or outsourced via managed services. The latter would specifically relate to activities that do not, or should not, act as a long term comparative advantage to banks, such as client on-boarding, corporate actions and securities settlement.

## A fairness-first, segmented approach

Finally, we have to accept that fairer and more efficient markets are a fact of a competitive environment; they're part of the new regulatory landscape. That means working out how to use data, tweak business models and get closer to customers as ways of thriving in this new environment is essential. Using customer data to highlight trends and patterns and to develop an in-depth

understanding of their needs will enrich positive relationships with customers by ensuring banks deliver the solutions at the right time to match their specific needs. As our research below indicates, banks are on the right track to meet customer expectations – but remain far off the benchmarks e-retailers have set as the norm.



Source: KPMG Customer Barometer May 2014

## REVAMPED BUSINESS MODELS

STEPHEN SMITH



Looking at how products and services are designed and sold is vital to profitability. Stephen Smith says banks that successfully deliver new business models can improve earnings and differentiate themselves at the same time.

The three ingredients for a successful bank are capital adequacy, funding and profitability. There is currently no great shortage of liquidity, and in Europe all but the weakest banks are able to raise additional capital where required. However, profitability remains an issue for most banks.

Our analysis of mid year results for 2014 shows that return on equity (ROE) is up on 2013 for the big UK banks. But in most cases it's still well below the levels seen at the turn of the decade. Importantly, it remains consistently below the cost of capital. That makes value destruction the number one issue for European banks.

This problem can be addressed via balance sheet optimisation (essentially, allocation of capital away from non-productive and toward higher margin assets and less capital-intensive businesses) or through operational change.

### **Cost cutting is not enough**

Operationally, a major lever is cost-cutting. A great example is Barclays. Its Transform plan

launched in 2013 has a range of objectives to deliver growth – including a cost-saving target of £1.7bn by 2015. But many banks are reaching a point where hammering costs is simply not enough. There needs to be a next step – a more definitive shift in the business model. And that has to mean cutting complexity.

### **Cutting complexity and improving transparency**

We are seeing good examples on this front. HSBC stated in its latest annual review that it plans to “concentrate on streamlining operations... reducing or eliminating complexity, inefficiencies or unnecessary activities... through a combination of simplifying and globalising processes, products, systems and operations.”

RBS is also benefiting from accelerating the rundown of poorly performing, capital-intensive assets through its RBS Capital Resolution unit. It reported that to 30 June 2014 RCR had already achieved £2bn net CET1 capital accretion since creation.

Greater transparency for existing business models and clearer planning for new ones is critical. Investment banking has been brilliant at creating highly sophisticated products, for example. But in too many cases, their lifetime cost and capital consumed have been opaque at best. New, simpler business models should prioritise the visibility of returns.

### **Leveraging digital technologies without hollowing out customer relationships**

Reducing the cost to market often by serving customers via online and mobile channels – has been a rising trend across all sectors. It will only grow in the banking world. Most banks have already embraced digital channels for many reasons – although cost reduction has been, perhaps, overemphasised among them. True, a growing cohort of ‘digital-native’ customers (and staff) is organically shifting bank business models. But this needs to be for the right reasons, with the right controls in place and set against the risk of hollowing out customer relationships.

### **Strip away non-essential back-office operations**

In many industries, a shared services model is common. The back office in banking is now ripe for change in that area. Some commodity services already operate collectively via third parties, of course. But there are other areas ripe for more use of

shared services – such as collating data on commercial customers to streamline transactions.

The overarching objective is centralised infrastructure platforms capable of supporting different businesses and customer propositions. These streamlined platforms allow new business models – including new products and services – to come on stream without complicating the single view of the customer or designing common processes from scratch. Less complexity and richer relationships should deliver better alignment between customer and shareholder value, which is the best business model of all.

“  
Simplicity is key  
– a well argued  
strategy that  
simplicity can be  
delivered with  
shared services  
can be sold to the  
regulators.  
”

# EFFECTIVE RISK AND CONTROLS

MELISSA ALLEN



One of the major tests for banking sector leadership is how they engineer compliance and control functions that meet new regulatory demands while still allowing banks to support their customers and flourish, as Melissa Allen explains.

Banks have continued to expand the resources focused on monitoring and control in response to the ever increasing volume of new regulation and the supervisory scrutiny of past misdemeanours as well as current practices. These pressures are unlikely to ease in the near term so how banks handle them is extremely important.

No one, least of all the banks themselves, has any desire to be caught out by control failures again, of course. All the banks are already putting in place more effective controls around the areas that have caused them, and their customers, problems. But the cost of endlessly increasing controls in response to regulation and current or future risks is not sustainable. Banks are reaching a tipping point around controls, where the knee-jerk of 'more' must be replaced by a strategy of 'better'.

Making this change requires addressing a number of key challenges:

## Aligning strategy, risk and control

The relationship of risk to strategy, expressed through risk appetite, remains challenging for many institutions, particularly in areas like operational, conduct and reputational risk. This uncertainty has, in turn, resulted in many controls having little relationship to a prioritised view of risk. Adding controls has become an objective in its own right, done tactically from the bottom up. But management can see that this approach to controls might undermine strategic objectives to expand products and services, or improve customer experiences.

## Clarifying accountability

Accountabilities for managing risk day-to-day can often be unclear, particularly where processes cross businesses and functions. As a result, gaps could arise. But, more often, we see overlaps – with each business area or function adding controls in layers rather than agreeing and relying on a single approach. Clarity of accountability also empowers individuals to shape

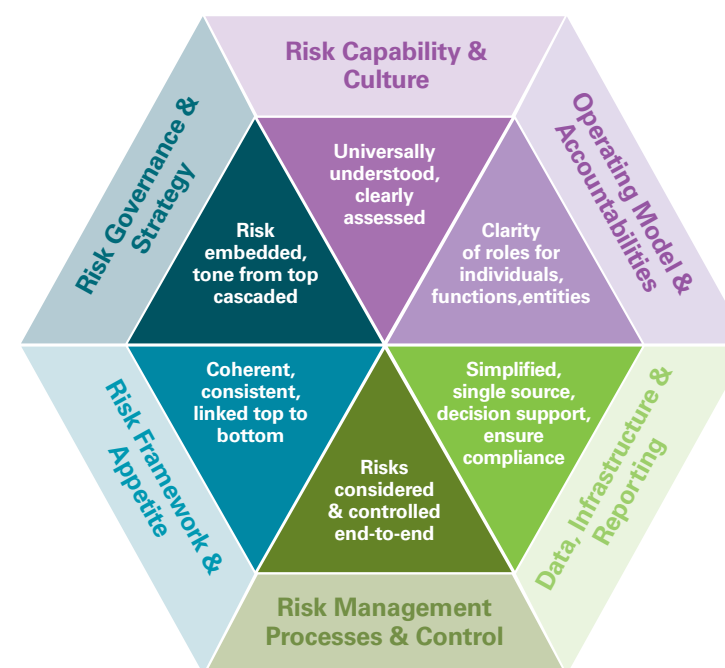
and invest the approach to controls and add transparency to the cost of control, enabling better risk and business decisions.

## Driving value, not volume

Layers of control have expanded because of tactical responses to problems. However, under-investment in technology infrastructure is also a key culprit. Rising expectations and the sheer volume of controls have been met with a rising headcount but this is unsustainable reaction. Applying the right technology and analytical capabilities should deliver more, and more effective, monitoring. At the same time, this would free human resource to focus on value-added analysis and advisory work.

## Data focused flexibility

Regulation and its requirements will keep changing. Banks have shied away from major investments in simplifying systems and data sources thanks to the scale and complexity of the task. But years of ever-increasing demands and scrutiny have been the compelling motivation for many to begin mapping out a



future IT architecture. The aim is consistency, flexibility and lineage to data that feeds key controls – and a platform that delivers higher quality information on risk and control to management.

## Implications for the future

By looking holistically at the information flows and controls already in place in the context of the wider enterprise risk assessment, it might be possible to lower the cost of new controls, eliminate

duplication and increase automation – delivering 'more for less'.

Aligning compliance and risk investment with other strategic outcomes – for example, controls to avoid future mis-selling could become part of the wider effort to deliver more customer-focused banking – and greater clarity and transparency over the cost of control will help management make more informed decisions about which businesses deliver the right balance of risk and reward.

Spending on regulatory compliance and control has taken away crucial investment from growing the business. Addressing these challenges offers an opportunity to create further the operating efficiencies banks need to free up resources – capital, cash and colleagues – to focus on building the business in a sustainable way.

## ROBUST CORE SYSTEMS AND DATA

NICK URRY



Technology can deliver the change the banking sector needs. But complex, poorly-understood legacy IT are damaging operational efficiency and limiting options, as Nick Urry explains.

Most banks have built their technology in-house over many years. Some of the core banking platforms can trace their roots back to the 1990s, 1980s and even earlier. On top of issues around ever-increasing complexity and scale, the architects of some of these systems are retiring, taking unique skills and knowledge of those systems out of the workplace.

This creates major problems. The scale and complexity of core banking operations and systems means there are no proven, 'off-the-shelf' solutions available that meet the entire core banking requirements in the UK. The very considerable complexity of the existing in-house IT landscape in the major banks also means that the existing core banking systems can't simply be surgically removed and replaced.

Any planned core IT upgrade (either re-architecting or replacement) will also have to manage integration with all the other in-house and external banking platforms, processes and utilities they're hooked into. This

challenge is likely to exceed the appetite of the major banks for both delivery cost and delivery risk unless there is a massive external justification for change. To further complicate matters, there are likely to be few COO or CIOs who would be confident that such an exercise is within the capability of their in-house IT.

This capability gap has emerged as successive IT projects added or extended components around the legacy platforms, but rarely de-commissioned functionality. Then most UK banks have traditionally treated IT as a commodity cost issue rather than a strategic differentiator. The last 10 to 15 years has seen a variety of IT downsizing initiatives, strategic outsourcing and offshoring agreements designed to drive down day rates.

The end result is a fragmented operating model, with core IT expertise distributed amongst a small number of in-house IT staff as well as in multiple low-cost offshore centres and external providers. Core systems may

be the foundations for any bank – but the keys to the castle are spread around contractors, retired programmers, offshore locations, outsourcing companies – and those running in-house silos.

Ideally in-house IT would have a single structure and operating model covering all of the core platforms, all of the integration layers and all of the key disciplines. This would address the complexity in the core platforms and the other strategic architecture components such as payments, digital channels, risk, finance, customers, and so on. The ideal IT organisation would also build multi-functional capabilities to manage strategic change programmes.

### A challenge to justify IT investment

The pressure for increased capital and profitability means costs remain under heavy focus and investment in new IT systems continues to be difficult to justify. One result could be an increased number of high-profile IT banking

failures – all the more public as a result of the increased prominence of digital channels. (These channels, of course, place additional strain on core systems.)

One solution is to recruit those with a deep technical background into leadership and decision-making roles. In many firms the choice of who should lead and manage the Technology team is made by non-technologists who pick people that appear compatible, align with the strategic vision, corporate style, trusted pair of hands etc, rather than picking outstanding technologists or delivery experts with a deep understanding of IT. Unpicking complex legacy systems and understanding how new and often unstated requirements can be delivered with limited resources may demand IT and even business leadership to have a much deeper and broader understanding for the raw engineering that will be necessary to get new IT architectures designed and working effectively.

A revised, more agile, more robust core banking platform will eventually run at a lower total cost than the current system – but only when the total cost includes managing ongoing changes in a more agile fashion; increasing resilience strategically through

software application and data rationalisation; strategic integration; and avoiding potential platform failures or compliance issues. That's going to need development of strategic in-house IT functions, re-skilling banks with the core engineering disciplines that enable IT to be a core differentiator.

The downside of failing to address IT platform issues isn't just limited agility and poor customer experience. Failure to address the inherent IT and platform risks threatens the survival of the business in the short term, and not being able to leverage IT for business advantage jeopardises bank survival in the long run. Then there's the urgent need for systems capable of meeting tougher regulatory scrutiny.

For example, the Basel Committee on Banking Supervision issued principles for effective risk data aggregation (RDA) and reporting last year. From January 2016, RDA supervisors will be able to ask banks for comprehensive reports aggregating huge quantities of data to support different risk scenarios within very short timescales – ruling out manual intervention and correction.

So we see four themes that will need to be addressed to improve core banking systems and data:

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**Failure to address the inherent IT and platform risks threatens the survival of the business in the short term, and not being able to leverage IT for business advantage jeopardises bank survival in the long run.**  
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**There are really four big themes that will need to be addressed to improve core banking operations and data:**

**1 Develop a strong, effective and operational, single view of customers**, separate from core banking platforms or data warehousing/analytics. That enables more effective actions at the point of customer contact (by whatever channel) informed by improved data analytics or insight, improves the ability to analyse business performance and helps to understand and track the actual performance of new products by customer segment and enhances customer experience through building rapport.

**2 Build a set of core-banking platforms** that are all used by all channels in the same way. Creating “product factories” with clean, standardised points of integration for customer-facing applications enables an increasing range of products to be supported and extended.

**3 Create a re-usable customer servicing architecture covering all digital channels** plus branch and back office to deliver a true multichannel capability to support the majority of customers and their key interactions without relying on human intervention.

**4 Build a payments architecture** that allows management of payments and liquidity more consistently for the bank and the bank’s customers.

There is nothing new in these themes. But enabling the CIO to manage their development over a multi-year timeline is very different to asking them simply to prioritise this year’s ‘must haves’ on a piecemeal basis. Longer-term projects necessary for stronger, more robust core systems require a shift of mindset by the business. Without that, the most likely outcome is that the underlying problems of complexity, a lack of control, misdirected budget and inherent risk of serious, client-facing platform failures is only going to get worse.





## IMPLEMENTATION OF STRATEGIC PROJECTS /

HARPS SIDHU



The banking industry doesn't have the best track record of large-scale change. Regulation, new operating models and cost pressures are now combining to make successful strategic initiatives a matter of survival, as Harps Sidhu explains.

Banking has historically been a high-margin activity – margins that meant the harsh efficiencies, discipline and strategic flexibility inherent in many other industries was lacking. Now margins are much tighter, the need for discipline has become acute. That demands strategic change – wide-ranging projects that alter the way banks do business. Some have already developed branded programmes to drive this change through, such as Barclays with its Transform plan or Standard Chartered with its five-by-five strategic approach. But all have explained to shareholders that they're committed to delivering change projects in the medium term. One common theme is simplification. But that is a huge challenge due to the size of the problem at UK banks, cobbled-together legacy infrastructure and a succession of tactical fixes. But there are opportunities for growth and efficiency within this web of complexity.

### Co-ordinated parallel change initiatives

Strategic projects that address highly complex businesses need time to work. Banks often spend many years and tens of millions

of pounds just to understand their current status, before they can even design the programmes to simplify a succession of processes. But parallel change initiatives that lack co-ordination between businesses and support functions can be harmful. Often we see banner strategic initiatives that fund and spawn a host of localised tactical projects rather than one integrated strategic project. This route can actually hurt co-ordination. Better alignment of projects also means the strategy doesn't suffer from overbearing short-term expectations that make crucial multi-year projects requiring large investment seem less enticing.

### Target the entire operating model

Centralised and tactical cuts – reduced headcounts and branch closures, for example – can deliver in-year savings. But banks need to target their entire operating model, as well as unravel how they'll manage new regulations and market opportunities. Operational discipline and partnerships between functions are key – especially around support services, automation and technology. That's one reason Deutsche Bank hired Boeing's Kim Hammond as its new CIO, bringing fresh ideas and expectations from outside the sector.

### Shut down low profit products

Although it's counter-cultural to organisations whose instinct is to focus on revenue, loss-making and low-profit areas need to be closed or divested. We're already seeing banks try to move out of parts of the fixed income market and certain geographies, for example. Without these tough decisions, any strategy is going to struggle – and won't shift the dial on costs.

### Visibility across all tiers of management

A bank's leadership team – and their ability to connect with the business via the middle tiers of management – is vital. Senior management has the visibility across the portfolio to spot strategic opportunities; can commit to the investment and time that strategic change needs; can align the businesses to a long-term vision; and be dispassionate enough to kill projects or activities that are draining resources.

It's that long-term, focused, disciplined, technology-oriented vision that will decide how well strategic change is implemented.





# THE POWER OF POSITIVE THINKING



BILL MICHAEL  
EMA Head of Financial Services



Banking is at a crossroads. Bill Michael highlights some of the reasons bank leaders should be optimistic about their long-term future – and some of the opportunities they have to thrive as the economy drives forward.

As the expert commentaries in this report highlight, the banking sector is at a crossroads. Recovery and remediation lie behind it – and are making way for growth and profitability.

As the UK economy rebuilds and businesses grow in confidence, they need banks willing and capable of lending their support. The data is encouraging. The latest figures on profitability suggest banks have turned a corner. Yes, return on equity remains subdued – and, worryingly, below the cost of capital. But factor in the huge remediation and conduct costs most of the banks are still carrying in their P&L, and the figures look more positive. Importantly, the H1 2014 figure is higher than the ROE in 2013.

There are challenges ahead, of course, but there are also reasons to think a brighter future for banks and their customers is there for the taking.

## Regulation is critical and will continue to refine banking

Regulation remains one of the critical components of a framework

that makes the banking system work. We need controls. Regulation is important because, despite all the other pressures, the culture in banking won't change on its own. It has to be imposed, in part, from the outside.

But while we respect the intentions of the regulators, there has been too much activity. Worryingly, we still seem to be some way off reaching what might be called 'peak regulation'. And, of late, there has been too little cross-border co-ordination and too much of a country-first approach which will impact economies of scale – and global trade will suffer as a result. This is particularly pernicious as one of the main roles of banking is, after all, to facilitate trade. For it to function freely, banking has to operate on a global scale.

Banks need to do their best to serve clients within the regulatory constant. At the same time, it is essential that governments and global regulators think about how they can refine the system whilst at the same time keeping it safe. The EU dialogue of late, and what will be debated in Brisbane at the G20 later this year, will continue to shape this agenda.

## A creative impetus from digital disruption

The emergence of shadow banking initiatives are creating a dynamic and challenging environment for traditional banks. Banks will need to become more agile and, in particular, get a grip on technology quickly. If they can do so, the opportunities are endless.

There is hardly a market or sector in the world that isn't experiencing the disruptive effects of new digital players. And banking is no exception. These digital disruptors have little in the way of legacy thinking or systems to hold them back and are able to jump on new developments quickly.

These challengers also present an opportunity to test new ideas and concepts on a small scale and bigger banks can take heart from the fact that it is not always best to be first to market. Staying on top of innovation – even if that is in non-core areas of finance such as high-street retail – and monitoring developments that work best mean it is still possible for larger banks to exploit groundbreaking market shifts. They have the advantages

of scale and reach – and existing customer relationships. It should be feasible for the large banks to be second or third to market, with a product or service that has been relatively well tested elsewhere. This reduces risk, without losing customer benefits.

## A strong position for those ahead of the cyber curve

System security is another major technology issue that can either be a threat to banks – or an opportunity to differentiate. Either way, it has become part of everyday operations. The threat of cyber attack has become a constant factor for all financial services firms. Banks in particular face diverse threats, from lone-wolf hackers and ATM scammers to organized cyber terrorists. Those responsible for system security have to be constantly alive to the shifting threat from new types of attack and new perpetrators.

Balancing the need for customer security and peace of mind with the need to access systems easily across an increasing range of mobile platforms will provide a stern test for every bank. Those that manage to successfully repel cyber attacks and keep ahead of the shifting threats, without alienating or making life too tough for customers, will be in a strong position.

## The new model army

It's not hard to imagine a world where people switch banking provider as quickly as they switch social networks. The ability to pre-empt such moves and deliver services that meet the needs of ever more demanding consumers is the real disruptive threat from challenger institutions. These newcomers can't match existing players for size or market share – but they can change consumer expectations about convenience, context and customisation.

Banks are no longer being measured against their direct competitors. Consumers don't think in convenient sector silos. A great mobile experience with a retailer has become the benchmark banks will be judged against – not whether a rival bank's app works better. In the age of disruption, uncertainty and change are the new norms. This presents opportunities for those who are prepared.

Demographic change is a critical factor. Young, digital-native customers already have been catered for alongside an ageing population. Then the majority of those just starting school will, by the time they graduate, be doing jobs that currently don't exist. What banking needs will they have?

At the other end of the age spectrum, a new type of hybrid 'working pensioner' will create different demands again. What place does brand loyalty have in such an environment? Brands able to generate trust and empathy from consumers alongside society benchmarked customer service models will thrive.

## The cycle of positivity

There is one certainty. The ruthless, growth-at-all-costs ambition of the stereotypical pre-crisis bank won't be back. (As bankers rightly point out, it was never truly representative of the industry in any case, even if it has defined the popular perception.) This is a new environment, defined by the ethical commitment of banking's new leaders, the scrutiny of society, the attentions of regulators, competition from new sources and transformative technology.

The road that lies ahead will be challenging. But there is a growing sense of self-belief returning to the banking sector – and this is welcome.

# BASIS OF PREPARATION /

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**This report summarises and makes reference to the 2014 mid year results of the following UK headquartered banks: Barclays, HSBC, Lloyds Banking Group (Lloyds), Royal Bank of Scotland (RBS) and Standard Chartered (SCB).**

Information has been obtained solely from published interim and year end reports (including analyst packs from results presentations). Where total numbers are presented, it is the total of the five banks in the review. As an example, total assets are the sum of the total assets of the five banks, expressed in sterling. Similarly, if an average number is presented, it is the average of the five banks in the review. We have used simple headline numbers in our analysis unless stated otherwise; each bank has its own way of reporting performance and this has proved to be the most consistent method of presenting their results. HSBC and SCB present their results in US dollars (\$). These have been translated into sterling using the relevant period end or period average rate. Where percentage changes are presented for HSBC or SCB, these percentages are based on the dollar amounts disclosed by the banks, rather than on the sterling translation of those amounts.

Note that any discussion of 'underlying' results reflects a number of adjustments to statutory figures, as determined by management. Underlying results will therefore not be comparable from bank to bank. Management reporting in the bank results focuses on underlying figures.

## **Adjustments commonly include:**

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- ▶ Elimination of currency translation gains and losses.
- ▶ Elimination of goodwill, profits and losses on acquisitions and disposals of subsidiaries and businesses.
- ▶ Exclusion of liability management gains or fair value changes on own debt.
- ▶ Inclusion of shares of profits of associates and jointly controlled entities with underlying non interest income.
- ▶ Exclusion of certain write-downs and one-off items.



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