Come in Number 27, your time is up*

Transaction Banking Compass

*connectedthinking

PRICEWATERHOUSECOOPERS

The range of risks confronting banking Chief Executive Officers is growing ever broader. Transaction banking has low business risk but complex operational risks, and in the current environment any operational failures could have disastrous consequences. Even so, research suggests that payment systems are a low priority on CEOs' risk radars. It is therefore vital for transaction banking risk management to be correctly positioned, prioritised and resourced. Chief Risk Officers should also consider the risk management implications of new regulation arising from the current crisis.

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A good night's sleep

Now more than ever, observers and commentators of the banking scene are trying to identify and address the risks that keep CEOs awake at night. Considering the industry's current operating environment, the question could not be more topical or important.

In theory, the answer should be most easily provided by those CEOs and management teams that have already established excellent risk management systems, employed the most talented risk managers, and that receive relevant and comprehensive management information from those people and systems. If there are any CEOs lucky enough to be in this situation, then they are more likely to be losing sleep over missed business opportunities than the prospect of unforeseen risks.

Unfortunately for the rest, ignorance is not bliss. An operational failure that damages reputation might end in no more than embarrassment; but inadequate stress testing of liquidity models or a failure to comply with sanctions lists or anti-money laundering obligations could lead to insolvency and a potential jail sentence. The latest Banking Banana Skins survey, published in April 2008 by the Centre for the Study of Financial Innovation (CSFI) in association with PricewaterhouseCoopers,[1] lays bare this heightened awareness; the survey showed the overall perceived level of risk in the banking industry to be at an all-time high.

Figure 1: Crisis characteristics

- Asset price deterioration
- Asset price volatility
- Bank insolvency
- Increased public ownership
- Increased retail deposit guarantees
- Record stock market falls
- Emergency funding liquidity injections
- Public ownership of toxic assets
- Emergency bank takeovers
- Real economy solvency issues
- Economic recession

Source: PricewaterhouseCoopers

The world is changing

The world has become more complex and unstable over recent years: more interconnected in its infrastructures and more dependent on electronic information processing. New threats are emerging and old threats are becoming more significant. The Banking Banana Skins survey and other analysis by PricewaterhouseCoopers demonstrate that the banking industry is currently facing a very broad range of risks.

An analysis of the characteristics of the global financial crisis in 2008 (see Figure 1) highlights the importance of effective risk management – and the consequences of getting it wrong. This is underlined by the way in which national governments have had to undertake co-ordinated recapitalisation of banks around the world, in addition to the substantial market support provided by central banks since the beginning of the crisis.

All the same, perceptions of risk tend to be heavily influenced by fashion and context. With wall-to-wall media coverage of deteriorating market events, it is no surprise that concerns about the availability of liquidity topped the 2008 Banana Skins index. Nonetheless, and despite the fact that the survey was conducted many months into the crisis, subsequent events suggest that the true nature and extent of this risk was even then not fully appreciated. Something is clearly wrong with the people and the systems.

Payment systems risk comes in at number 27!

A central theme of the Transaction Banking Compass is that many banking groups are overlooking or underestimating the importance of their transaction banking businesses.

Overlooked transaction banking opportunities do not only comprise operational benefits, such as potential economies of scale and efficiency gains. They also include hidden earning streams that can be leveraged to create significant new value for shareholders. By the same token, however, transaction banking may pose underestimated risks. This does not just relate to operational issues that could generate substantial customer complaints; it also represents a full range of potential risks that require effective risk management. The values involved are very high indeed.

The 2008 Banking Banana Skins survey illustrates the degree to which this risk has been underestimated. Despite the potential significance of transaction banking risks to other items tested, respondents put payments systems at number 27 on a list of things likely

[1] PricewaterhouseCoopers' refers to the network of member firms of PricewaterhouseCoopers International Limited, each of which is a separate and independent legal entity.

Figure 2: Banking Banana Skins 2008

1. Liquidity	16. Corporate governance
2. Credit risk	17. Management incentives
3. Credit spreads	18. Emerging markets
4. Derivatives	19. Back-office
5. Macroeconomic trends	20. Retail sales practices
6. Risk management techniques	21. Conflicts of interest
7. Equities	22. Political shocks
8. Too much regulation	23. Business continuation
9. Interest rates	24. Money laundering
10. Hedge funds	25. Environmental risk
11. Fraud	26. Banking overcapacity
12. Commodities	**27. Payment systems**
13. Currencies	28. Merger mania
14. Rogue trader	29. Too little regulation
15. Technology dependence	30. Competition from new entrants

Source: CSFI Survey in association with PricewaterhouseCoopers
Areas of related impact

to keep CEOs awake at night (see Figure 2). This puts transaction banking risk almost at the bottom of the list, a position it has consistently occupied since the inception of the survey more than ten years ago.

One interpretation of this finding could be that payment risks are well understood, systems are effectively managed and that contingency arrangements are in place. An alternative interpretation would be that the scope and scale of transaction banking risks are not well understood at the appropriate level of the organisation. Many people are working hard to ensure that the first interpretation can be justified, and there is certainly no room for complacency in their organisations. For others, the more concerning interpretation is also the subject of much debate and requires their action.

Transaction banking is a low business risk and high operational risk enterprise

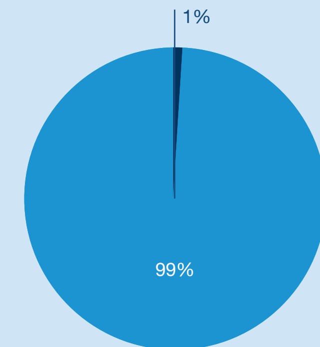
Financial businesses face many different types of risk, ranging from pure business risks to pure operational risks. While the current financial crisis is characterised by business risks such as excessive risk appetite and weak funding models, a transaction banking crisis would more probably be characterised by operational failures, counterparty defaults or a significant incident. Even if some of the consequences or outcomes are similar, the nature of a transaction crisis would be substantially different.

Transactions are the lifeblood of a bank and its customers: obtaining liquidity at the beginning of the business day, servicing customers during the day, clearing and settling interbank obligations and unwinding assets at the end of the business day. Transaction banking is also a high-volume business, and one that touches more customers more frequently than any other banking activity. Customers typically have little tolerance for transaction errors and this means that accuracy, reliability and certainty of processing are vital: all day, every day.

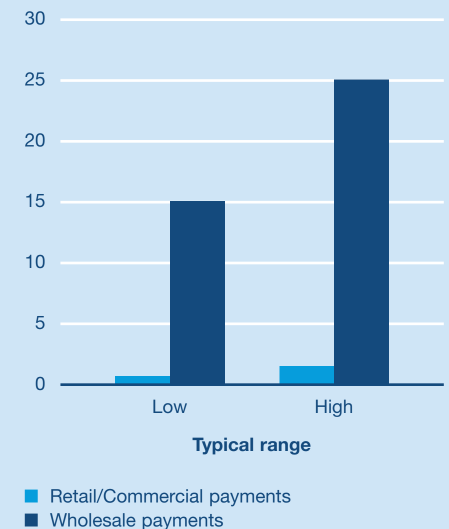
For example, a typical large national transaction processor may transfer anything between £0.75–1.5 trillion in low-value commercial payments and £15–25 trillion in high-value payments in any one year.
The typical relationship between the volume and value of transactions processed is shown in Figure 3.

Figure 3: Low-volume/high-value payments mix

Typical clearing bank volumes



Typical clearing bank values (trillion £)



Source: PricewaterhouseCoopers

On a peak day this means that the exposure from a market-leading clearing bank could be in the region of £1.75–3 billion in relation to low-value clearings and £100 billion in relation to high-value clearings. The scale and complexity of this exposure makes it clear that transaction banks require specialised risk management processes. It is also vital for risk management teams to have a deep understanding of the operational risks inherent in the business.

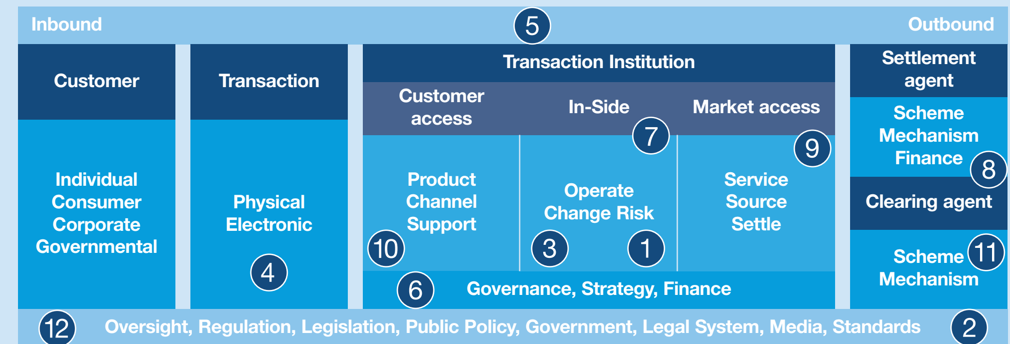
Overall management of transaction banking is all too often crisis driven

Transaction banking activities tend to suffer lengthy periods of underinvestment, which are only punctuated by forced and costly spending when problems erupt or regulators intervene. Caught between the two stools of neglect and panic, managers often struggle to carve out a role for transaction banking in enterprise strategy or long-term investment planning.

At the heart of this issue is an inability to correctly identify either the value or the risks of transaction banking businesses. It is notoriously difficult to get whole organisations engaged with infrastructure business cases, which often struggle to compete with seemingly more attractive investments in new business propositions. It is this lack of engagement that explains why transaction banking activities are frequently fragmented across a banking group, regarded as a utility instead of a business, and under-represented within organisations' leadership structures.

Figure 4: Key payment risk trends and implications

1. Outsourcing of key operations
2. Clearing and settlement dependencies
3. Shortening clearing cycles
4. Sophistication of fraud
5. Increased operational threat profiles
6. Scarcity of experience and skills
7. Processing system age and complexity
8. Third-party infrastructure consolidation
9. Regionalisation of schemes
10. New channels
11. 'Deregulation' of clearings
12. Regulation



Source: PricewaterhouseCoopers

The need for better recognition and specialised risk management points to two requirements:

1. Positioning transaction banking properly within the bank, with full responsibility for its own profitability and return on capital employed; and

2. Delivering excellent, reliable performance, based on insightful management information and effective risk management.

The scale and scope of the resulting transaction banking business will depend on the size, complexity and market positioning of the wider organisation within which it sits. While investing in full-scale transaction management technology and operations sufficient to support an in-sourcing strategy may be appropriate for the three or four banks that dominate a national market, it is unlikely to be appropriate for smaller organisations.

Transaction banking risk needs to be correctly positioned, prioritised and resourced

Transaction banking businesses are subject to a number of ongoing risk trends, in addition to being affected by the current credit crisis. Some key ongoing risk trends are highlighted in Figure 4 above, along with their non-exclusive positioning in a typical transaction banking value chain.

The potential relationships between these trends and the most highly ranked risks identified by the Banking Banana Skins surveys should be of particular concern to senior management. In the current climate, an operational incident which prevented a high value payment from settling could have serious and disproportionate consequences. Similarly, the relationship between payment scheme rules and insolvency law is much more likely to come under stress when very substantial payments are involved.

Risk is an unavoidable element of any business; the difference between success and failure lies in the ability to identify and manage it. This means having effective risk management systems, run by experienced people able to recognise the full range of potential risks and respond accordingly. Accountability for risk cannot be outsourced, even if the responsibility for risk management is. For payment institutions this is codified under Article 18(2) of the Payment Services Directive, which states that 'payment institutions remain fully liable for any acts of their employees, or any agent, branch or entity to which activities are outsourced.'

Risk should also be managed where it can best be controlled. The relationships between different risks therefore need to be well understood, with interdependencies clearly identified and control responsibilities agreed in advance. Without this clarity, incidents in one part of the supply chain can easily result in avoidable problems elsewhere. This is where

the experience and talent management of an organisation can really tell.

Where do we go from here?

The typical progression of a crisis can be broken down into a number of discrete phases, and although the degree of detail ascribed to each phase can vary, the following three consistently emerge:

1. The Management Phase;
2. The Recovery Phase; and
3. The Prevention Phase.

The global economic crisis is currently in the Management Phase, but attention is now beginning to shift to the Recovery and Prevention Phases. In this instance, the implications of Prevention Phase activities have the potential to be challenging and far reaching. It is safe to assume that regulation will be the dominant outcome, and that much greater transparency and rigour will apply than has hitherto been the case.

For the Chief Risk Officer of a transaction bank this means several things:

1. Managing those risks that directly relate to the current crisis and its recovery.
2. Establishing an appropriate risk management scope, strategy and execution plan: see Integrated risk management framework (Figure 5). Extended execution will be vital for risk management to be effective into the upstream supply chain.
3. Distinguishing which risks are internal to the business and which are external. In each case it must be clear whether the risk is to be managed within transaction banking or elsewhere.
4. Enabling experienced people to make effective use of their knowledge: ensuring early recognition of areas where a risk is becoming an issue.
5. Monitoring and influencing the changes to risk management required by the political, regulatory and market responses to the current crisis.

Figure 5: Integrated risk management framework

Source: PricewaterhouseCoopers

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