Banking and Capital Markets

The future of banking

Returning stability to the banks and the banking system

July 2009

1 Introduction

Over the past 18 months financial services have changed fundamentally and permanently. Before the crisis, systemic risk was a subject for abstract theoretical discussions and seen as something for others to worry about. Derivatives, securitisation, risk management and the Basel banking regulations were thought to have made the world a safer place, not a more dangerous one.

Then everything changed. In the PricewaterhouseCoopers[1] paper, 'The Day After Tomorrow', we offered a perspective on the global financial crisis and examined how the foundations of financial service institutions have been shaken to their core. The speed and intensity with which financial markets changed, combined with the scale and complexity of banking models exposed the structural weaknesses of major players. Some global institutions have disappeared, while only a few are able to survive on their own and gain market share.

Typical reactions to the crisis have been short-term in nature, in many cases driven by the need for survival. Short-term actions alone will not suffice and fundamental questions need to be asked and issues tackled. A few leading institutions are beginning to address those fundamental issues and prepare themselves to prosper in the new world while most have not begun the process. This paper explores a number of these questions, and subsequent papers will examine specific topics in more detail.

The key questions

How will institutions address risk management, capital and liquidity requirements? The need to take risks, hold capital against those risks and manage mismatches in positions through effective liquidity management is fundamental to banking. The fundamentals have not changed. Many of the assumptions that were used to model these fundamentals in the past have changed for good. Businesses that were once seen as profitable are now uneconomic; businesses once seen as safe are now seen as reckless.

Institutions will need to be able to make robust decisions based on sound understanding of true profitability after having reflected the return required for the risk and the capital used.

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

How will banks make money in the future? Banking is of vital importance to the global economy; therefore a successful, profitable and competitive financial system is essential. Banks must determine which customers they will serve, in which markets and with what products. There is, however, no guarantee that size will be the key to success, or that existing banks will be able to preserve their franchise. Shareholders have already penalised those banks that built up poor credit portfolios; they will soon start to reward those banks that can generate profitable revenues without taking undue risk.

What will the regulatory environment be like and how will individual institutions need to respond? High-profile regulatory action has already been taken. This process will continue and institutions will need to demonstrate a greater degree of compliance with the new regulatory requirements.

Many of the institutions that have failed had comprehensive governance structures. Were these structures fundamentally flawed? Banks must ask whether those charged with governance have the right skills, individually and collectively, to be able to challenge constructively and must ensure oversight functions have access to all the information needed to effectively analyse the risks the business faces.

Finally, how well will business models survive and will they be efficient? The changed market environment has exposed weaknesses in business models, but while no bank has the luxury of starting from a clean sheet of paper, maintaining the status quo is also out of the question. Most major banks are a complex web of geography and culture, as well as products/services. This has resulted from years of organic growth, mergers and acquisitions, as well as the organisation's response to product innovation, regulatory responses, tax changes, globalisation and regionalisation initiatives.

The efficiency of an organisation's business model will be judged by the alignment it has to the strategy and the way in which it facilitates the most productive use of unique capabilities.

It is of critical importance to address all of these key priorities, in the right order, and to ensure the responses are aligned. This is what will differentiate the leading institutions from the second-tier players in the future, and ensure survival in the new world.

2 Executive Summary

The global financial crisis has shaken the foundations of financial service institutions to their core. Industry conditions have changed fundamentally and permanently and banks need to act quickly to develop comprehensive plans, first to stabilise their businesses and then to move forward.

Banks must decide on their strategy and how they can build the right business model to deliver it. Nothing less than a world-class approach to the management of capital, risk, regulation and governance will suffice. To help deliver their strategy, banks must focus on employing the right people, while rewarding them fairly and transparently.

Strategy

Banks must first address their own balance sheets. After securing their capital and liquidity positions, ring-fencing their toxic assets, bringing assets on balance sheet and providing full transparency, banks need then to review their competitive position. Even for those institutions that do not have significant exposure to toxic assets, the economic cycle is putting 'non toxic' assets under pressure. While they don't require 'ring fencing', they will need a significant amount of management time and attention.

The future belongs to organisations that can first identify the market segments where they add value and where there are customers who are willing to pay for their products, and then have the courage to invest in these businesses while shrinking others. Effective monitoring of progress against strategic goals will be fundamental to future success – the management of change might seem mundane in these times of crisis, but implementation will, as always, be the differentiator.

Banks being resuscitated by government funds need to concentrate on their core competencies, existing customer relationships and market share in order to compete. Those who are unhindered by large government shareholdings and substantial writedowns will have significantly more flexibility to exploit their relative strengths and will try to improve dramatically their competitive position by a combination of organic growth and acquisitions.

Cost reduction is a priority for all banks and tools such as activity-based costing should be used to achieve a fuller understanding of the cost base. Banks should not just cut costs; they need to be strategic and seek to modernise their business. They must simplify and reduce the complexity that has built up over many years, better integrate their processes and systems, and better connect the different parts of their businesses that serve their customers. In short, they must focus on increasing efficiency rather than just relying on headcount reduction to achieve their new cost targets.

Banks must fundamentally challenge the design of their control systems and governance, which need to be simple and appropriate. If banks are not thorough and do not spend sufficient time and effort on redesigning these systems and controls where required, then regulators will move to enforce very significant control frameworks on the industry.

Business model

As banks look to the future, transitional change will probably be insufficient – structural and transformational change must be considered. Regardless of changes to the business strategy, the way that strategy is delivered will certainly change.

Transformational changes to the business and operating model are rarely undertaken, but the current environment provides a 'perfect storm' of the driving forces behind such wholesale reconstruction: dramatic adverse changes in financial performance, significant regulatory intervention and substantial changes to leadership teams.

Short-term survival is clearly critical, but, as balance sheet stability is restored, banks need to consider appropriate business and operating models that will ensure their long-term survival. The urgent need to address short-term financial considerations can lead to longer-term mistakes when assessing which assets are core and which are non-core. Instead, these longer-term decisions on which assets are vital to the new strategy need to be derived from basic thinking around the customer value proposition and the ongoing ability of the bank to derive value from that model having regard for the appropriate levels of risk versus reward. Banks will need to consider the appropriate mix of products and services they can deliver and manage, where they sit on the mono-line – universal bank continuum, the balance between distribution and manufacture, the ability to scale and the effectiveness of embedded control.

The future will probably bring changes to whichever part of the value chain banks choose to operate in, particularly for the universal banking model, where most will recognise they lack the scale and reach to serve fully their franchise with owned product and infrastructure. The nimble, who have a fully developed, needs-based customer value proposition will understand that packaging an appropriate set of products and services together, some of which might be white labelled from others, adds more value than providing a limited range of fully owned products and services.

Banks need to understand clearly all the different aspects of their business and operating model because they are intertwined – decisions to change one part of the model will have significant consequences for the other aspects. This interconnectivity makes structural change highly complex and the process of change can, in itself, be a cause of operating model failure. With this in mind, banks must be wary of poorly thought through or knee-jerk reactions.

Capital, risk, regulation and governance

Capital is now a scarce commodity and the people, processes, policies and systems that govern its deployment will have to become more effective and robust. Capital and funding structures will become simpler and lower returns on equity will become the norm. Basel II will be transformed, with higher capital requirements and capital buffers that flex over the economic cycle to give better counter-cyclical protection.

There will be significant changes to the techniques used to analyse how much capital is required, particularly in relation to credit risk across the cycle and also to address the limitations of value at risk models. Broader funding, liquidity and operational risks are under greater scrutiny and banks will become smarter at measuring, monitoring and limiting their liquidity risks and building a better assessment of liquidity risk into their business decisions. The desire to understand risk profiles and risk behaviours is greater following the crisis and we believe that economic capital models remain a useful tool to do this – albeit with requirement.

Banks have to face the possibility of embedded regulation. We expect regulators to take a 'back to basics' fundamentalist attitude towards regulation and be more hands on and take a more international perspective. Banks, however, have to play their role in ensuring that regulators do not overload them with potentially damaging regulation.

The opacity of banks' organisation structures and processes has not helped in the management of their risks. In certain circumstances this problem has been compounded by ineffective non-executive director (NED) or supervisory board oversight. Governance, risk and compliance need to become more prominent. This will require a re-examination of the way that these functions are viewed. We believe the conditions are right for this change to occur and for these functions to play a stronger, more challenging role in the governance of financial institutions. The level of tension between the second and first lines of defence can be expected to rise.

People and rewards

People, rewards and culture have without doubt played a key role in the development of this crisis. Management must make it a priority to develop better ways to fairly reward while not encouraging inappropriate behaviour. Reforms will take significant time and effort to get right and will only deliver their full benefits in the long run.

Changes to reward systems and governance are the most urgent in the short-term, and are the focus of greatest public, government and regulator interest. Displaying a responsible and well thought through approach to compensation will be an important part of reputation building for financial services institutions, and will also play an important role in bringing about change.

Appropriate risk-adjusted measurement systems should be cascaded further down into the business, ideally to business unit level. There also needs to be a more balanced set of measures. The determination of deferred compensation needs to be brought closer to the value of the business that generated the bonus in the first place, while striking a balance between individual accountability and a partnership ethos. It is equally important that appropriate qualitative risk-based oversight of bonus pool determination is established. The role of discretionary judgement about quality of earnings – linking information about risk with information about compensation – is vital.

Compensation will only ever be a part of a change agenda. Financial services institutions need to build strong and resilient cultures in which responsible risk-taking, within the risk-appetite of the firm, simply becomes 'the way we do things around here'. This will require different approaches to reward, development, performance management, communications and recruitment.

3 Strategy

3.1 Renewing strategic direction

The problem with panic

More than six months have passed since the collapse of Lehman Brothers, and a year and a half since the collapse of Northern Rock triggered the first bank run in the UK in more than a century. Yet many banks are operating as though they are still responding to the original panic – as shown by a lack of strategic direction, continuing injections of capital from government, ongoing board, management and organisational restructuring and rapid cost and headcount reductions. In addition, the latest series of losses, among the biggest in corporate history, provide a stark reminder that many institutions are still in a perilous position and that the financial crisis has some further time to play out.

Yet, operating as if still in panic mode is dangerous. Banks risk making short-term, reactive decisions, which will damage their long-term profitability. The banks that have survived will continue to survive and it is unlikely that governments would let another major bank fail. The actions of banks in the next 12 months, therefore, will determine who will be the winners and losers in the long run.

Developing a vision and strategy that builds confidence

This does not mean banks can return to their old practices. Instead, banks need to ascertain their true strategic, competitive position in the marketplace. CEOs need to consider the actions that are vital in the short-term, while restructuring their businesses for the long-term. Based on the new reality, they need to redefine their objectives, attitude to risk, business model, people management and remuneration. They must ask who their customers are and how they relate to them, the products and geographies they serve, and how they communicate to the markets and other key stakeholders.

A clear strategy that builds confidence will have the welcome side effect of encouraging liquidity to flow again. But these actions must be taken in the right order. A strategy follows a vision: banks, while focused on survival, need to keep their eyes on the long-term vision. Articulating a coherent vision and building consensus that encompasses the different interests of stakeholders is undoubtedly a difficult challenge, but is critical in this period of change.

3.2 Balance sheets and bad assets

Address the balance sheet first

At a macro level, the industry has to put its house in order before it can fully engage in lending again. The longer it takes for banks to get their businesses straight, the longer it will be before they can return to the business of banking – lending money and facilitating the flow of capital. Clearly governments through their various support schemes are seeking to ensure bank lending can be increased as soon as practical, although banks themselves may prefer to return funds to government rather than increase exposures in difficult markets.

History has demonstrated that banks that clearly address their balance sheet problems are quicker to stabilise their liquidity and capital strategies, and emerge from a crisis in the strongest position. In order to communicate that they fully understand their exposures – which is necessary to increase transparency and investor and market confidence – banks will need a clear approach to ring-fencing their toxic assets, as well as providing additional clarity around the profitability and exposures of 'non toxic' portfolios.

The challenge will be for banks to ensure they are sufficiently capitalised, in an environment where there might be differing views on the inherent value of their business. The current market might require them to write down the value of their business, even though in the long-term they are confident it has a higher value. The risk is that when raising capital banks will have to set new issuance at prices low enough to be attractive to investors, which could inflate the levels of capitalisation required.

The PricewaterhouseCoopers paper 'Stabilizing and reviving the financial system', published in May 2009, explores these challenges in further detail.

Focusing on client relationships

In a world with less liquidity, banks need to focus their scarce resources on clients and markets where they have distinct capabilities. This means banks need to understand their own advantages in the marketplace and need to focus effort and capital where they can win. Clearly banks need to think twice before taking assets out of their balance sheet, however attractive the returns may appear. It also means not wasting precious resources on clients and segments where the bank is unlikely to earn the required return. This is a major mindset shift from the previous era, where balance sheet expansion almost always resulted in apparent profitability, driving banks to enter a variety of new client relationships and markets, which were not ultimately value creating. Investing in the right client relationships with a view to the longer-term will boost organic growth and pay dividends in the future.

In doing this, banks need to manage their client relationships very carefully, as it is likely that a number of clients will have both good and bad assets at the bank, not to mention deposits that will help with the banks' liquidity. In this situation, consistent client communication and an orderly process for exiting toxic assets will help to reassure clients of their position with the banks.

Surety comes at a price

A number of banks have selected to participate in asset protection schemes (APS) or government structures, as these give a degree of certainty over the potential losses the bank could incur on the assets insured by the scheme. This, in turn, provides investors and other banks with an improved degree of confidence in the ability of the bank to weather the current and future economic storms and that risks are being properly managed.

While in principle we believe APSs are a useful tool in managing their toxic assets, we would advise management to:

- Stress test the balance sheet under a number of challenging scenarios in order to see how and when they might benefit from joining asset protection schemes (APS).
- Undertake a robust cost-benefit analysis to understand fully the downside of joining these schemes – the fee for joining, the level of government interference or influence that will be attached to them, the burden of administering them and potential shareholder dissatisfaction.

- Evaluate the stress test and cost-benefit analysis and form an overall perspective on joining the APS. If management still believes it is beneficial they should enter into negotiations with the relevant parties to secure the best possible price for entering the scheme.

A symbiotic relationship

There has already been a significant impact on bank behaviour from government ownership, both at the banks that are government-owned and from the knock-on effects in the market for non-state-owned banks. However, almost all market participants predict that government ownership of banks will eventually come to an end and a number of major institutions are already taking steps to reduce government stakes in their banks. We believe it is not too early for forward-looking banks to start thinking through how this exit might take place and how it will impact the competitive landscape and to position themselves accordingly.

Demand for credit and the need to lend

The financial crisis has led to a simultaneous deleveraging of banks, companies, and consumers (with a commensurate increase in borrowing by the government). While this might be the optimal response for an individual, in aggregate it is unfortunately exacerbating the economic downturn.

In this situation, with very scarce capital, banks need to be very careful with their existing clients and manage this need to deleverage with long-term relationships in mind, both for consumers and for corporates.

Similarly, in the interbank market, banks need to think carefully about where to place their excess liquidity (to the extent they have any!), particularly as the government's interbank guarantees are removed over time. Banks need to ensure their counterparties are solid, and will be required to demonstrate their own financial strength. Over the medium term, this should lead to much better transparency and an overall stronger banking system.

In a market where the overriding direction is to deleverage, paradoxically there will also be pent-up demand for credit. Ordinary consumers are often being denied access to funds as the mortgages and loans that were easily obtained over the past few years have dried up. The policy of aggressive lending to those individuals who were unlikely to be in a position to repay the debt will not return, at least in the short-term. But people will soon need and expect to be able to borrow at least 70 per cent of the cost of buying a house. The majority of retail banks need to return to offering acceptably priced mortgages in the relatively near future although clearly not at levels that are unprofitable with simple goals of building market share.

In addition, banks need to begin lending to each other again to keep the pool of credit in financial services from drying up. Before they can do that they need to be certain that their counterparties are viable and properly managing their exposures. Once this larger uncertainty is dealt with, they can then turn fully to wealth-generating activities.

Each sector of the market will have its own particular dynamics and areas such as small and medium-sized enterprise (SME), corporate and cards will have its own challenges for growing profitable market share. However, those who are able to understand and respond to customer requirements will gain traction most quickly and should be able to improve their competitive position.

3.3 Strategic cost reduction: time for a quantum leap

Don't just cut costs: modernise

Management undoubtedly need to reduce costs dramatically as they shrink the size of their businesses. Blanket redundancies, however, are not the answer. Banks must adopt an intelligent approach as short-term, indiscriminate cost-cutting seldom pays off in the long-term.

Banks should take this opportunity to modernise their businesses. They must simplify and reduce the complexity that has built up over many years, better integrate their processes and systems, and better connect the different parts of their businesses that serve their customers. In short, they must focus on increasing their efficiency rather than just relying on headcount reduction to achieve their new cost targets.

Such changes will take time. Many banks have excessive and inefficient structures as too many investment decisions are taken on a short-term basis. Longer-term solutions are required, and many will not pay back in a year or two. Understandably, institutions want to be able to report progress to the market quickly; however, this is not always possible, as for some, this will require a strategic shift in the cost base.

The relationship between cost, return and risk

In the past few years, banks have often reacted to potential shortfalls in quarterly profit by taking on increased risk. As investors' return expectations kept increasing, this became a continuous process, which ultimately was unsustainable and was a key contributing factor to the financial crisis. In addition, as banks sought out higher-return, higher-risk strategies, this increased the overall complexity of the bank and ultimately drove up the cost base, in turn prompting further risk-seeking behaviour. The crisis has brought this lesson home, and all stakeholders will benefit from banks taking a good look at their costs, returns and risk, and ensuring these are in a sustainable equilibrium.

Managing return expectations is also part of a responsible and sustainable banking environment. Banks will help themselves by providing investors with realistic return scenarios and consider doing away with overambitious total shareholder return targets. Banks can also help themselves by communicating clearly that while return on equity (ROE) might decline, risk-adjusted ROE will not fall as much (or could even increase) as the bank's risk profile declines.

Transparent reporting of real profitability

Generally, few banks have a good understanding of the costs and profitability of specific products, customers and channels. This is a consequence of weak cost-allocation practices, poor management information and a strong sales and revenue orientation that has prevailed for years. As long as the balance of total revenue and total costs was a positive one, not enough critical questions were asked.

Basic banking needs to become profitable again to stop banks from having to take excessive risk. To achieve this, banks need to better understand the profitability of their products and (finally) get to grips with their cost bases, using a reliable and robust cost allocation method and transparent pricing.

The price of costly and complex products

Sophisticated non-financial institutions have developed efficient and rapid product development processes that ensure a reliable stream of well-engineered and profitable products. Banks should follow this trend and review and upgrade product design processes. The discipline of involving a range of stakeholders in product development and approval, increasing understanding of the product target segments, and being clear on the risk profile and product control processes should allow a simpler, more effective, and more profitable banking product set to be developed.

3.4 Growing organically and through acquisitions

For those who have time and money, opportunities abound

For those who are emerging as the stronger players, opportunistic acquisitions will potentially be a way to achieve an ROE and secure growth in the medium term. But banks that continue to make acquisitions in the new environment should not over-leverage their purchases, which nervous markets have shown will not be tolerated.

However, during the current phase of deleveraging, for those with cash and time, a very targeted acquisition strategy will allow them to improve substantially their competitive position in markets where they already have a good position.

More sophisticated customer management

If and when increased choice and new providers return to the financial services market, customer and client relationships will become more important, as the power in the relationship swings back to the consumer. Therefore, while simplifying their business structures and unworkably complex products and instruments, banks need to take a sophisticated approach to identifying, segmenting, targeting and servicing their customers and clients.

There is a high probability that the present crisis has heightened customer awareness of the value that they should be deriving from a relationship with a bank. Too often in the past, that value has not been apparent or matched to the amount that the customer has been paying. When customer confidence returns and supply levels return to normal, customers will judge banks on how well they sustained their relationships with their customers during the downturn and will be more sensitised to value for money from products and banking relationships. This heightened demand will present a considerable challenge to many banks, particularly as banks struggle to rebuild profitability and balance sheets, and will require much more precise customer information and insight than has generally been available in the sector.

For new entrants the time is now

While banking in general has been dramatically impacted by the financial crisis, many areas of retail banking remain inherently highly profitable. This fact has not gone unnoticed to non-financial companies with strong brands and resources. A number will enter the banking market looking to take market share from traditional banks, as:

- Many retail banks will be preoccupied with survival, restructuring their businesses and reducing their cost bases. These initiatives will take considerable management time and energy and there is therefore a high potential that they will take their 'eyes off the ball' or their responses will be limited by the fact that they are still in recovery mode.
- Many are capital-constrained and have significant, costly and time-consuming legacy issues to overcome if they are to transform their performance and the service they provide to their customers.
- Regulation will significantly reduce the revenue banks obtain from penalty fees. As many traditional bank business models are predominantly based on net interest margin and penalty fees, this probable erosion, together with their scarcity of capital, will again limit their responses.
- The reputation of banks is at an all-time low and according to a recent UK survey (conducted by Mintel in January 2009 on behalf of the BBC), some 30% of consumers are very unsatisfied with the service they receive from their bank.

An additional consideration is that as a result of the impact of capital constraints as well as accounting rules (such as fair value and purchase accounting), opportunities for private equity firms, insurers and others to buy banks have increased.

Although many of the 'newer' and less established competitors have left the financial services market during the current financial crisis, which has to some extent reduced competitive pressures, we anticipate that new entrants will be drawn into the retail banking market. They will challenge the traditional players through a combination of innovative and simple products, better customer services and better use of technology to access their banking products and services. There is no killer punch that existing banks can deliver to head off this new threat to market share, but it reinforces the need for clarity in determining target customer segments and executing effective strategies to reach and satisfy those segments.

3.5 Preventing future crisis

A vision of right-size regulation

Regulators largely failed to spot the crisis that blew up the world's financial system and rightly they remain nervous about the ability of the banks to withstand future shocks. Successive and ongoing injections of cash into the financial system, including from government and central banks show that it is difficult to know where the bottom of the crisis really lies.

Regulatory scrutiny of many institutions has rightly increased and they are requiring more rigorous stress testing using a wider range of scenarios to be conducted. In addition regulatory demands for information from banks have increased significantly.

Further and better regulation will be required as part of the restoration of confidence. But regulation alone will not solve the problem: in particular, it is the enforcement of good governance, the right behaviours and right rewards that will restore confidence in the banking sector, enabling the banks' financial position to be rebuilt. The new and reconstructed banks should implement robust governance structures quickly to persuade regulators that they have a good grip on their affairs, thus encouraging the regulatory focus to be at the right level and not to stifle the industry with excessive bureaucracy.

Redesigning the system of controls

Banks must fundamentally redesign their control systems and governance, and in so doing stick to making them simple and appropriate and strive to avoid overly elaborate or convoluted systems. If banks are not thorough and do not spend sufficient time and effort on re-designing these systems and controls, then regulators will move to enforce very significant control frameworks on the industry. If this occurs, this will potentially move banks further away from a sustainable solution, as increased pressure to be compliant with these significant control frameworks will only increase costs. In turn, this could have the opposite effect from that intended, leading to greater risks being taken by bank management teams as they try to find the level of returns that investors demand. The present mood, though, is likely to drive the regulatory model more down the path of detailed regulation and away from principles-based regulation.

Lessons from the past

Successive waves of failures in banks have taught us a number of lessons that remain unheeded:

- First, that integration of group-wide control functions – risk, compliance, finance, human resources and internal audit, and, in particular the co-ordination of these between the front, middle and back offices – has been woefully inadequate.
- Second, that senior management in the banking industry has to varying degrees ignored the warnings they have received from these control functions. This has been starkly illustrated by recent press reports of the warnings management of a number of banking groups apparently received concerning their banks' cultures and management practices.
- Third, that the complexity of banks in terms of products, customers, geographic coverage and cultural norms has proven to be a serious block to allowing them to properly understand and therefore manage their risks. This has been further compounded by their over-reliance on quantitative risk analytics, which have subsequently proven to be flawed.

Given these lessons and the catastrophic failure of the banking industry, it is in the interests of the government, taxpayers, regulators, investors and the banks themselves to ensure that these lessons are learned and that the required remedies – for example, better integration of the control functions and the modification of the banking sales/risk cultures – are properly implemented and their effectiveness approved by the boards of the banks and their regulatory authorities.

3.6 Conclusions

Banks need to act quickly and develop comprehensive plans, first to stabilise their businesses and then to move forward. After securing their capital and liquidity positions, ring-fencing their toxic assets, bringing assets on balance sheet and providing full transparency, they need to review their competitive position in the new financial world and understand the opportunities and threats this poses.

The competitive positions of many financial institutions have been dramatically affected by the financial crisis and their actions over the coming months will determine how well they compete in the future. We believe those banks being resuscitated by government funds need to concentrate on their core competencies, existing customer relationships and market share in order to compete. Those who are unhindered by large government shareholdings and substantial writedowns will have significantly more flexibility to exploit their relative strengths and will try to improve dramatically their competitive position with a combination of organic growth and acquisitions. We believe the time is right for new competitors to enter the consumer banking market and that they will seek competitive advantage through stronger brands that inspire greater confidence in the minds of retail customers by using a combination of innovative and simple products, better customer services and better use of technology.

Strategic cost reduction is a priority area of focus for all banks. They need to fully understand their cost base and use tools such as activity-based costing to help achieve this understanding. Management should take this opportunity to modernise and better integrate its processes, systems and businesses, and better design its products so that their cost and complexity is reduced.

To avoid the problems of the past and a disproportionate regulatory crackdown, banks must fundamentally redesign their control systems and governance. However, they need to keep it simple and appropriate and must better integrate all of the functions that assist in the process of control.

4 Business model

4.1 Where are we now?

The financial services sector has been blessed by a benign business and regulatory environment over the last decade, which masked a number of unsustainable business models within the industry. But a more awkward truth for many is that the financial crisis and wider global recession have challenged the core operating models responsible for delivering the business strategy.

As banks look to the future, transitional change is probably insufficient – structural and transformational change must be considered. This is not simply a case of conducting a review of the business model and reassessing the value proposition of the bank, but understanding how the future business model will be delivered. Regardless of changes to the business strategy, the way the strategy is delivered will certainly change.

This type of change is hugely complex. There are many aspects of the business and operating model to consider and these are encumbered by legacy practices, processes and systems that frequently represent the cultural core of the organisation. Transformational changes to the business and operating model are rarely undertaken, but the current environment provides a 'perfect storm' of the driving forces behind such wholesale reconstruction: dramatic adverse changes in financial performance, significant regulatory intervention and substantial changes to the leadership team.

Change in financial performance

The period 2001–2007 was one of uninterrupted growth in financial services, underpinned by increasing gross domestic product (GDP) growth, expansion of global trade, ample wholesale funding and low inflation. Unprecedented volatility and a sharp downward trend in financial performance from 2007 onwards has prompted an urgent need to restructure balance sheets, reduce costs and improve risk management, but it has also highlighted the reality of operating performance over the last decade.

The initial findings of PricewaterhouseCoopers research[2] shows that improved operating efficiency – when measured by cost/income – has been driven by strong income growth rather than significant improvement on the cost side. Strong levels of GDP growth underpinned the expansion in income, but so too did higher levels of balance sheet leverage through increased use of wholesale funding. With liquidity risks now better understood, it is increasingly clear that apparent improvements in operating efficiency over the last decade were at least in part achieved through increased exposure to liquidity risk.

Regulatory intervention

Regulators have discovered that their rules have proved ineffective in both predicting and preventing the crisis. They have been forced to intervene where an entity is failing or at risk of failing and, naturally, they have demanded fundamental changes to the organisation in return for coming to its rescue. Most of the big global banks, which have been judged too big to fail, have resorted to support from the lender of last resort – the government. The larger the intervention, the bigger the changes demanded.

2 To be published in summer 2009.

Changes to leadership

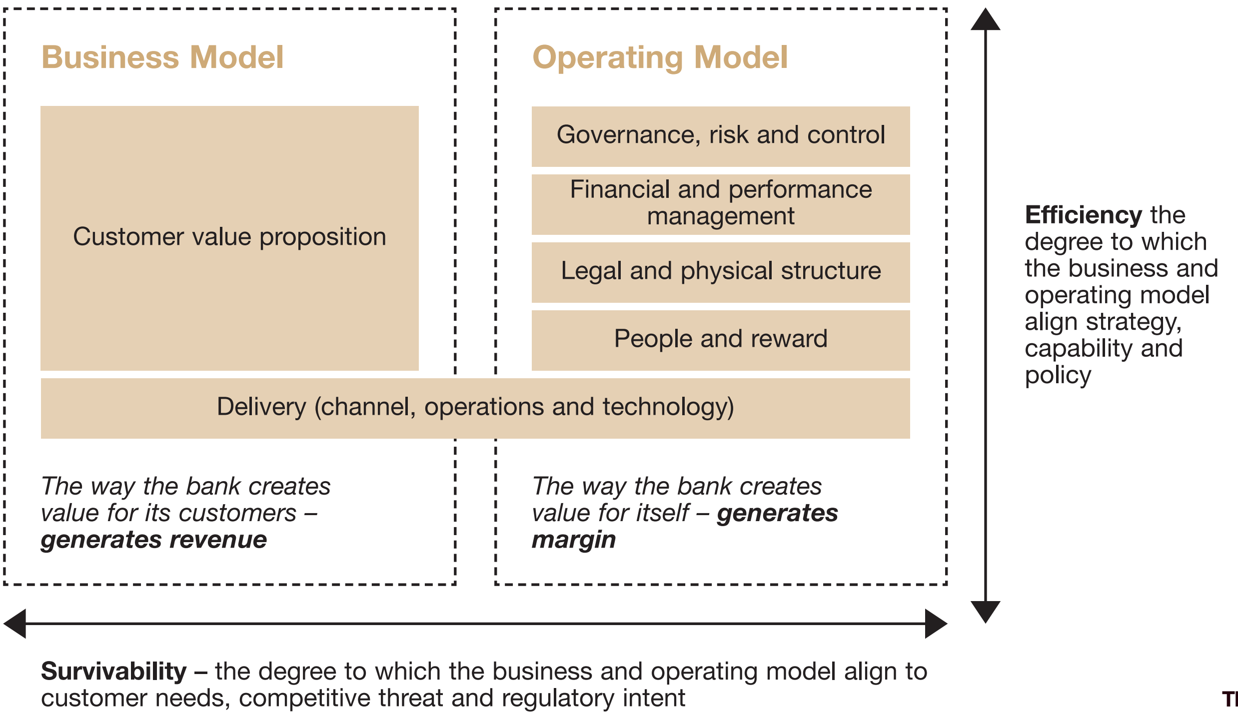
A new team at the top, whether appointed through succession, acquisition or forced change, will want to establish their own vision for the organisation. This new vision then cascades down through the organisation in the form of changes to the business and operating models.

These drivers, particularly when they converge, are a trigger for substantial change. Banks, however, must consider the structure of their business and operating models, not simply in terms of efficiency, but the degree to which they can survive.

4.2 Business and operating model dynamics

The business model represents the value proposition to the customer; it is made up of the products and services for which the customer will pay and success will be defined by the degree to which customer needs are met. While the business model can be configured in a number of different ways, customer segment, product and geography are typical for many banks.

The operating model is made up of the functions required to support, control and manage the delivery of the products and services that make up the customer value proposition. Typically, these functions are not directly paid for by the customer, but might be integral to the product or services offered – business support functions. Alternatively, they are functions that are required to support, control and manage value creation for the bank itself – corporate functions. While they can be grouped in a number of ways, we consider five core operating model functions: governance, risk and control; financial management; delivery (channel, operations and technology), legal and physical structure; and people and reward. (See diagram below).



Source: PricewaterhouseCoopers

Governance, risk and control

Addressing the overall levers of control and management, this is the function that is central to the decision-making required to drive sustainable value creation. Current key questions include: how are the board and non-executive directors (NEDs) measured, is the executive robustly supported and challenged, are controls and policies embedded within the business and are these controls and policies adhered to when they clash with the business model?

Financial management

Financial management has line of sight on the overall profitability of the bank and will increasingly need to align costs appropriately to the business model. Lower returns and higher capital ratios will result in financial management having greater involvement in product design and franchise targeting. Current key issues include: simplification of capital and funding structures (see legal and physical structure), responding to new patterns of supervision, aligning internal performance reporting and emerging external techniques for analysing and valuing bank performance.

Delivery

The delivery function typically spans both operating and business model in that it encompasses the core business support functions discussed earlier. Current key issues include: platform resilience and redundancy, strategic sourcing and managing supply chain security and scale through shared services.

Legal and physical structure

The structure of the bank legal entity will come under increasing review – recent bank failures have highlighted the complex legal entities that have developed at a number of institutions, often without any alignment to business and operating model efficiency. As banks consider the best ways to ensure funding, regulatory alignment and tax efficiency (including appropriate use of recent tax losses), the legal and physical structure of the bank will probably require realignment and simplification.

People and reward

Reward across the business model needs to be reconsidered, both to ensure it is genuinely aligned to long-term sustainable value and allows the functions that determine the sustainable profit of the business to stand on equal footing to those that generate its immediate revenue. Section 6 in this paper discusses key current topics: incorporating risk into performance measures, design of deferred compensation and remuneration governance in detail.

Banks need to understand clearly all the different aspects of their business and operating model, because they are intertwined – decisions to change one aspect of the model will have significant consequences for the other aspects. For example, changes in liquidity regulation and strategy could require changes to the legal entity structure. Changes in risk appetite could define targeted customer segments and the use of low-cost geographies could impact on product and service performance. This interconnectivity makes structural change highly complex and the process of change can, in itself, be a cause of operating model failure. With this in mind, banks must be wary of poorly thought through or knee-jerk reactions.

4.3 Survival – more than just a short-term problem

As discussed in the earlier section on strategy, knee-jerk reactions to the current situation can undermine both the customer and bank proposition. The new financial environment is creating both challenges and opportunities, but hasty decision-making, either in the form of disposals or acquisitions, can destroy value. Significant examples of both of these situations have been seen in the past 12 months. Short-term survival is clearly critical, but, as balance sheet stability is restored, banks need to consider appropriate business and operating models that will ensure their long-term survival. Replicating the existing model with a few bits cut away or bolted on will not prove sufficient.

Core verses non-core

A number of banks are considering which of their assets are core and which are non-core as part of a strategy and business model review. But the urgent need to address short-term financial considerations can lead to longer-term mistakes. Assets considered for disposal are usually identified by the ease with which they can be carved out, their distance from the centre of the organisation and their immediate market value. The very nature of this decision-making process means the underlying business and operating model will probably remain unchallenged.

Longer-term core versus non-core decisions need to be derived from basic thinking around the customer value proposition and the ongoing ability of the bank to derive value from that model. Banks will need to consider the appropriate mix of products and services they can deliver and manage, where they sit on the mono-line – universal bank continuum, the balance between distribution and manufacture, the ability to scale and the effectiveness of embedded control.

Understanding the customer

Banks need to go back to thinking about customer needs and the way these needs are met. Customer segmentation models are traditionally broken down by geography, turnover or income, and industry group or demographic, but this type of segmentation originated from a credit-based relationship.

As the cost of capital and liquidity increases, a fundamental repricing of balance sheet capital usage will occur. Sophisticated banks, however, will think beyond repricing and look at the underlying segmentation of their customers to seek out areas of profitability that are less dependent on capital consumption. There is a long-term trend in the industry away from net interest income (NII) to non-NII revenue sources (non-NII revenue rising from about 25% of total revenue in 1980 to 45% in 2000). This trend is likely to continue and current segmentation and relationship models should be challenged. In a recent PricewaterhouseCoopers survey[3] of corporate treasurers the primary way these key bank customers measured the value they created for their own institutions was through managing the bank relationship, and the predominant way they measured the value of that relationship was cost.This suggests that this part of the business model should have been questioned prior to the current financial crisis.

3 'The world has changed', PricewaterhouseCoopers – 04.08.

Manufacturing – do you need to own it?

Banks must also consider the mechanisms through which they deliver the customer value proposition. Internet banking models have proved that the once-strong link between the size of the branch estate and market share can be challenged. White-labelling and product-aggregation models have proved that franchise ownership is not dependent on owned products and operations, while originate-and-distribute models have demonstrated that a bank need not be constrained by its own balance sheet when servicing customers' funding requirements.

The future will probably bring changes to whichever part of the value chain banks choose to operate in, particularly for the universal banking model, where most will recognise they lack the scale and reach to serve fully their franchise with owned product and infrastructure. The nimble, who have a fully developed, needs-based customer value proposition will understand that packaging an appropriate set of products and services together, some of which may be white labelled from others, adds more value than providing a limited range of fully owned products and services.

These emerging models will require a different set of skills in terms of managing the delivery components of the operating model – security of the supply chain will become increasingly central to operations, while risk management and people and reward programmes will need to reflect this skill set change.

Achieving scale

Margins in financial services will be increasingly tested. There has been a step change in the available revenue pool and while pricing and costs are being adjusted, a 300lb man that loses 30lbs is still overweight, however many notches on his belt he claims to have tightened. Banks will need to look for transformational cost reduction and this will be found through scale in all aspects of the business. Previously discrete areas will be deconstructed and synergies sought through shared services in low-cost locations. Coverage models will need aligning internally and to the customer, while historical branch and subsidiary structures will require reviewing in terms of regulatory alignment, funding requirements, tax efficiency and contract efficiency. Every aspect of a bank's business and operating model will need to be scaled or, if it is not, have specific and clearly understood reasons why.

Embedding control

An essential element of the operating model is the efficiency with which it generates value for the bank. The current financial crisis has highlighted the degree to which banks' operating models failed to fully control their businesses as they developed. For example, the way business growth plans were developed and driven while disconnected from risk appetite models; how control staff were ignored by the business and boards lacked the confidence, or insight, to challenge the executive. In future, banks will need greater focus on the sustainability of their business models and that requires clear governance and embedded control.

Overall, considerations around customer value proposition, end-to-end ownership, scale and control, raise questions about the future of the universal banking model and the degree to which those institutions using that model can remain focused, scaled and controlled enough to optimise shareholder value.

4.4 Conclusions

The strategy section of this paper identifies the problem of institutions becoming stuck in 'panic' mode and discusses the directionless inertia that it can create. This inertia can be compounded by the scope and complexity of the change that is required. As organisations set our their plans for the future, both in terms of positioning (business model) and delivery (operating model), they need to understand the complexities of achieving their goals. We consider five complexities when undertaking transformational programmes:

- Business model complexity. Understanding the scope of the value proposition and the way it is delivered.
- Process complexity. Deconstructing business processes to achieve cross-process scale.
- Organisational complexity. Realignment of the organisation to new business and operating models.
- Contractual complexity. Security and optimisation of the bank's supply chain.
- Cultural complexity. Challenging the way things are done and replacing the reference points that provide day-to-day certainty.

The leadership at banks face a considerable task in setting out their vision for the future. The first step is to define the strategic principles of the business and operating model and to understand their impact. The second step is to ensure alignment and common understanding of the principles across the leadership team, and the third is to communicate.

5 Capital, risk, regulation and governance

5.1 Revising capital structures

The scarcity of capital and its implications

Capital, which once flowed in abundance, is now a scarce resource, even for those firms benefiting from state support. This will create a significant need for the people, processes, policies and systems that govern its deployment, to be robust and effective. As a consequence, this will have implications for management information, management reporting, funds transfer pricing, product design and balance sheet management.

Simplifying capital and funding structures

Complex instruments have caused complex problems for the banking industry and the global economy. Securitisation in its familiar form is likely to disappear and special-purpose vehicles have been fundamentally discredited. As a consequence, banks' capital and funding structures will become simpler over time, although it could take several years for this change to work through.

Expect lower returns and higher capital ratios

The banking industry and investors must accept an uncomfortable truth: lower returns on equity will become the norm. It is recognised that previous levels of leverage will no longer be acceptable in the future and political pressure to keep lending prices low to encourage economic activity will slow the pace of revenue growth. While short-term volatility will lead to an increase in the cost of equity, we believe that it will return to long-run averages in the medium term. Banks must therefore concentrate on actions that will bring long-term profitability and contribute to market stability, building confidence that will also help to improve their market ratings.

In addition to yielding lower returns on equity, concern over the stability of financial institutions will lead to demands for higher ratios of equity to assets. Regulatory and investor concerns over the ability of banks to withstand future shocks have and will continue to lead to a requirement for higher Tier 1 ratios. This is needed to neutralise the countervailing forces of high levels of write-offs for consumer and corporate defaults as the recession bites. These will reduce earnings and the capital buffers available.

Providing a level regulatory playing field

In response to the understandable theme of protecting national interests, regulators have to provide a level playing field and protect banks that take a responsible stance on capitalisation. They are also concerned that opportunities for regulatory arbitrage are not providing perverse incentives.

The pro-cyclical nature of Basel II

This has emerged as a bigger problem than either the industry or regulators recognised. We expect banks to hold more equity capital in good times than in bad times and regulatory approaches to capital and funding will become much more counter-cyclical. Basel II Pillar 2 Element 4 (capital planning and stress testing) is likely to play a very important role in this, because this is the mechanism by which banks and regulators can impose additional capital buffers that flex through the economic cycle.

Other options such as dynamic provisioning are being considered, but this presents challenges under IFRS, which requires losses to be incurred before they can be realised. The UK FSA is also considering the introduction of 'variable scalars' under Pillar I to convert ratings from Point-in-Time to Through the Cycle.

In any event the industry has the view that bigger buffers need to be built up in benign times to protect against stress events. This needs to be done in a transparent way as opaque general reserves permit the ability of stakeholders to gain a real understanding of the relative strengths and weaknesses of different institutions. As always, the industry will need to take a proactive stance with regulators to guard against a regulatory overreaction.

Is Basel faulty?

The crisis developed in a Basel I world. Basel II, however, is being criticised as a contributory factor. We do not believe the Basel II framework is fundamentally flawed, but the methodologies used to calculate capital requirements need refinement, simplification and the removal of unnecessary complexity. We also believe that greater attention needs to be devoted to Pillar 2 to ensure that it is applied more effectively. Enhanced guidance has already been proposed by the Basel Committee, which expects senior bank management to:

- Understand the firm-wide risk profile;
- Define risk appetite in a manner that considers long-term performance over the cycle;
- Set clear incentives across the firm to control risk exposures and concentrations in accordance with risk appetite and to capture firm-wide risk concentrations arising from both on- and off-balance sheet activities.

Changes to the pattern and methods of supervision

'The way in which capital requirements and the actual level of capital vary through-the-cycle is as important as the absolute minimum level. There are strong arguments for taking action to avoid unnecessary procyclicality but also for introducing overt counter-cyclicality into the capital regime.'

Lord Turner, The Turner Review, A regulatory response to the global banking crisis, Financial Services Authority, March 2009.

This recommendation from Lord Turner is considered by many commentators to be a very significant one, which indicates that the present capital adequacy requirements introduced under Basel II will undergo fundamental transformation.

Reversing the present regime by increasing capital requirements during good times is a counter-cyclical measure aimed at reducing the probability of a recurrence of the recent series of banking crises. New importance will be given to supervising capital adequacy using a through-the-cycle approach that enables the banks to understand their risk position in good and bad economic times.

5.2 A new meaning of risk

Changes to how risk is analysed

Transformation will not end with new counter-cyclical measures. It will also involve increasing the level of capital banks should maintain, in order to account for market shifts and to accurately reflect the level of risk held on their trading books.

Changes will be required in the techniques used to analyse how much capital needs to be held, particularly the value at risk (VaR) methodology, which is used to estimate the probability of portfolio losses based on the statistical analysis of historical price trends and volatilities. The historical approach has failed in this crisis to take into account the low (but real) probability of catastrophic events that can and have occurred.

Trading activity and potential losses on the trading book will come much more sharply into focus. As liquidity has disappeared in over-the-counter (OTC) markets, and products that once were liquid are now regarded as 'toxic' assets – such as securitised mortgages or credit default swaps – the magnitude of risks on a bank's trading book will be supervised more closely as a key indicator of the strength of the bank as a whole.

Along with capital adequacy, limiting the liquidity risks that banks face and ensuring a better understanding of market-wide liquidity risks is set to become a key area of focus for the Financial Service Authority (FSA) in the future.

Misplaced confidence

The crisis laid bare the shortcomings in how banks price, monitor and manage their risk. As we argued in The Day After Tomorrow, 'too much reliance has been placed on quantitative models, based on historical data, to make assessments of current and future risk exposures. In future, risk management culture must be strengthened by designing organisational structures with risk at the centre and aligning compensation structures accordingly.'

Low interest rates, freely available credit and liquidity, and a herd mentality were characteristics of the asset bubble, which led to misplaced market confidence and an overvaluation of assets. Although the scale of the current crisis is unprecedented, this misplaced confidence in the inevitable rise of asset prices and high levels of leverage was also present in previous boom periods. The strengthening of risk management culture must address deep-rooted behavioural traits that have been a consistent feature of the financial system.

Smarter management of funding, liquidity and operational risks

Attention that was once focused on the quality of assets in the balance sheet is now being expanded to cover broader funding, liquidity and operational risks to which banks are exposed.

Banks will have to become far smarter at pricing their liquidity risk and building it into business decisions such as new product evaluations. Unsurprisingly, we anticipate most banks will take a more conservative view on risk. One consequence of this will be an increased appetite for longer-term savings products in order to reduce the asset liability mismatch. This might match the mood of consumers, anxious to build some stability into their future. But to attract significant volumes of long-term savings, banks will need to develop new long-term savings products that are more transparent, so that consumers can understand why they will really benefit from investing in them.

Economic capital: still a useful tool

Although economic capital models, for example in relation to market and credit risk, have been challenged by recent events, we believe that economic capital will continue to be regarded as a useful management tool.

The desire to understand risk profile and risk behaviour is much stronger, following the crisis. The limitations of economic capital, however, are better understood and are unlikely to be forgotten for a long time. Revalidation of economic capital models (data, modelling methodology) is clearly needed. There will also be increased reliance on stress testing to explore future events. Major revisions to budgeting and planning processes are required to embed a new rigour in an institution's business-as-usual processes and to allow a more integrated approach to risk, capital and value management.

No sacred cows

A sweeping change of culture in the management of risk is needed. Banks need to ask whether their risk-management models are sound and if not, introduce simpler, more transparent risk-management frameworks with clear accountability. The banks need to be able to distinguish better between different risks and regulate them accordingly. They should also make further attempts at integrating frameworks that bring together risk management, performance management, capital management and liquidity or funding management.

5.3 The changing regulatory environment

Change has begun

On 18 March 2009, Lord Turner released his proposals on the regulatory actions that he believes are required to create a stable and effective banking system. His detailed report highlighted what went wrong and what can be done to fix the problems, covering a range of issues from trading risk valuation to specific product regulation. Many commentators saw this as a positive move towards restoring London's reputation as a leading global centre for financial services – a reputation that was built on financial stability and a sound regulatory structure.

In many respects Lord Turner reached similar conclusions to those that were reached in another recent report that Jacques de Larosière delivered on reforming financial supervision across the European Union (EU). This harmony bodes well for the delivery of co-ordinated regulatory change on an EU level and on the wider international stage. The Financial Services Action Plan (FSAP) for Europe may now be seen as all but complete, after 20 years of painfully slow and incremental change. We now face a new era in which both the UK and the EU openly agree that the pace of reform needs to be accelerated rapidly.

The US authorities are initiating a comprehensive reform of their own system of financial regulation as part of what US Treasury Secretary, Tim Geithner, has called a "...determined effort to lead a race to the top in regulatory and supervisory standards". This action has not been taken in splendid isolation as he has readily acknowledged that US efforts will not be successful without parallel action in other financial systems. It is envisaged that the new Financial Stability Board (FSB) will play a critical role in leading this international co-operation.

The impetus from the G20

The recent G20 Summit in London delivered some practical changes to enhance the effectiveness of international regulators working together. The mandate of the Financial Stability Forum (FSF) was broadened and all G20 countries have been brought into its membership. A renamed Financial Stability Board (FSB) will hold a decision-making plenary meeting twice a year, with seats weighted towards the size of countries' economies and financial sectors, together with a number of standing committees on particular issues.

The membership of the FSB will have a much larger membership than the FSF, having added the G20 countries not in the FSF (Argentina, Brazil, China, India, Indonesia, Korea, Mexico, Russia, Saudi Arabia, South Africa and Turkey), as well as Spain and, significantly, the European Commission. FSB members will be obliged to maintain the stability, openness and transparency of their financial sectors, to implement international financial standards and codes of good practice, and agree to undergo periodic peer reviews.

The difficulty will be making this work effectively in practice. But the future appears to hold a new determination to work more closely to deliver regulatory solutions in areas where regulators have often had little influence or success:

- Greater disclosure by offshore tax regimes and enhanced transparency;
- A drive towards globally agreed principles of reward and sound structures for remuneration;
- Understanding trading risks across global financial institutions and the need to retain sufficient capital to manage the risks.

5.4 Who governs the banks?

The need for transparency and clear accountability

The opacity of banks' organisation structures and processes has not, in a number of circumstances, allowed for effective governance and the crisis has illustrated that many boards did not have the skills, experience or insights into the detailed workings of their banks to fully understand the risks they were taking.

The UK tripartite arrangement for governing financial regulation is seen by many as having failed banks and their customers. In addition, regional and global governance and regulation has also failed the banking system (e.g. the US withholding £8bn from the European arm of Lehman Brothers or the Republic of Ireland's unilateral decision to guarantee deposits to retail customers causing cash outflows from the UK). Many countries also experienced similar challenges. The interaction of global financial institutions with country-specific legal entities, regulatory provisions and insolvency laws has been a major contributor to the challenges in quantifying the impact of the crisis and resolving it.

Changing perceptions within banks about value and sustainability

The proposals in the recent Turner report will only help transform banking culture and working practices in a profound way if their implementation addresses the need for change in the concept of value within the financial services industry.

For the last decade, the concept of value has been rooted within what seemed to be a never-ending upward spiral of increasing ROE. Commensurate rewards were given to those people within banks who delivered new products, new financial engineering and new ways of leveraging and hedging risk.

The focus on the front offices of investment banks in pursuit of these goals meant that much less prominence, time, attention, recognition or reward was devoted to those who sought to exercise diligent governance or who attempted to manage the risks of banking engines that were 'running hot, about to blow'.

The failure of prominence for governance, risk and compliance

Governance, risk and compliance functions across the industry have at times struggled to gain true recognition at a senior level – particularly when annual results have surged, year-on-year.

While their importance has frequently been publicly acknowledged to the outside world of credit-rating agencies, shareholders and regulators, internal politics have often led these functions to be perceived as unnecessary costs to the business, and potential inhibitors to further growth. In some institutions, chief risk or compliance officers were not represented or lacked influence over key executive committees whose responsibility it was to discharge oversight and control over the business.

The changes ahead – opportunities to rebalance prominence

After the financial crisis, the new and increased focus on international governance, stress testing, scenario analysis, liquidity and capital adequacy, should mean that the value of governance, risk and compliance functions should become more apparent.

With increased regulatory scrutiny, the challenge will be for these professionals to manage their new relationships with the regulator and to ensure their voice is heard within the business. Executives within financial institutions must, in turn, acknowledge the need for change and offer greater prominence, recognition and reward to those charged with ensuring that the future growth of the organisation is sustainable.

Given the impetus provided by Lord Turner, the time might be right for these often undervalued functions to highlight their value proposition and get themselves placed firmly back on the corporate agenda of helping deliver sustained and stable growth.

The role of non-executive directors

In line with the principle of increased prominence, risk management should be accountable to a non-executive board director. Before this can happen, though, the question must be asked why NEDs or supervisory boards were, in a number of cases, revealed to be ineffective. Boards should consider what alternative forms of senior-level governance structures might replace or strengthen frameworks to provide the effective level of oversight that is required. A key challenge is to ensure that non-executives have the right skills, expertise and experience to provide an effective counterweight to executive decision-making. In some cases this could be addressed by making greater use of independent experts to assist on risk matters. In the UK the FSA now undertakes interviews for candidates for the roles of chair, CEO, finance director or risk director in authorised firms.

5.5 Conclusions

Capital is now a scarce commodity and the people, processes, policies and systems that govern its deployment will have to become more effective and robust. Capital and funding structures will become simpler, lower returns on equity will become the norm. Basel II will be transformed, with higher capital requirements and capital buffers that flex over the economic cycle to give better counter-cyclical protection.

There will be significant changes to the techniques used to analyse how much capital is required, particularly to VaR models, which the crisis has shown to have largely failed. Significant attention is being focused on the broader funding, liquidity and operational risks that banks are exposed to and banks will become smarter at pricing their liquidity risks and building a better assessment of liquidity risk into their business decisions. The desire to understand risk profiles and risk behaviours is greater following the crisis and we believe that economic capital models will still assist management in this area.

Banks have to face the possibility of embedded regulation and we expect regulators to take a ‘back-to-basics’ fundamentalist attitude towards regulation. However, banks have to play their role in ensuring that regulators do not overload them with potentially damaging regulation.

The opacity of banks’ organisation structures and processes has not helped in the management of their risks and in certain circumstances this problem has been compounded by ineffective NED oversight. For governance, risk and compliance to become more prominent, this will require a re-examination of the concept of value and a change in the way that these functions are viewed. We believe the conditions are right for this change to occur and for these functions to become more prominent and to report into the oversight levels of an organisation. Banks need to review the effectiveness of their board level oversight as the use of NEDs to provide this has not always proven to be effective.

6 People and rewards

6.1 A fair system of reward

It is now more than six months since we completed our study into reward in the financial services industry – Reward, A New Paradigm?[4] It is extraordinary how much has happened since then.

Several major financial firms have collapsed. Many others would have done so but for government support on an unprecedented scale. Barely a week seems to go by without a regulator or government announcing a review or issuing new guidance on remuneration in the sector. We undertook this study last year because we anticipated that remuneration in the sector was going to be a hot issue. However, even we did not anticipate quite how hot.

So this is a good time to reassess the issue. One thing is certain – we can remove the question mark from the title. There is undoubtedly a new paradigm emerging for reward. A full report on our conclusions is available on request. The key highlights are summarised here.

Be careful what you wish for

Although there is broad consensus on many aspects of this new paradigm, there are also growing risks of an over-reaction. Let us agree that there is a need for reform. Let us also recognise that pay levels in some pockets of the industry will fall. But a vibrant and effective financial services industry remains central to the health of the global economy. We must allow the industry to flourish, supported by appropriate remuneration systems – albeit ones that are more aligned to the risks taken than has been the case in the past.

Clearly the post-mortem in relation to the financial crisis will continue and has some way to go. But looking forward, the industry needs to attract and retain talent and align remuneration appropriately with performance. Now, more than ever, the industry needs talented individuals to lead it through a period of huge uncertainty and change. So reform is essential. But it is important not to act in haste and repent at leisure as unintended consequences are revealed. Let us be careful what we wish for.

Forces for change

Regulators, although moving at different speeds, are increasingly aligned in their recognition of the importance of remuneration as an issue of relevance to financial stability. They are in active dialogue on the issue, in large part through the auspices of the FSF. We anticipate an increasing level of convergence on the principles that should govern regulation of remuneration. The UK FSA has been an early mover with its remuneration Code of Practice, published in March 2009. The momentum for change has increased significantly as a result of the FSF's publication of its principles for sound compensation practices. Endorsed at the G20, these lay the framework for rapid and co-ordinated international implementation of regulation in the area of compensation.

4 'Reward: A new paradigm?', PricewaterhouseCoopers – 09.08.

Governments are also becoming increasingly involved in the remuneration debate in the sector. This involvement is taking two main forms:

1 Remuneration conditions for firms participating in various government support programmes, which might be industrywide for general access programmes, or negotiated on a firm-by-firm basis where firm-specific support is put in place;

2 General reviews of governance and remuneration in financial services, such as the Walker Review in the UK, and the Treasury Department review in the US.

When we were carrying out our study over the late spring and summer of 2008 there were some who thought that the whole remuneration issue was going to go away. The biggest barrier to change was first-mover disadvantage. Regulators were identified as a force for change by only 13% of respondents, and were ranked seventh out of 10 such forces.

The widespread involvement of governments in providing capital to the industry has significantly reduced the argument of first mover disadvantage. Change is now inevitable. And few today would identify regulators as anything other than a major force for change.

What needs to change?

There is much congruence between the principles emerging from regulators and governments globally, while financial firms themselves are also recognising the need for change. Central to the debate is how remuneration can be structured so as not to encourage excessive risk-taking, and, importantly in the current environment, how firms can demonstrate that this is the case. The key issues for financial services firms addressing this core question can be collected under the following three headings:

1 Incorporating risk into performance measures – how can firms ensure that bonus outcomes adequately capture the risk assumed in generating profits in a given year?

2 Design of deferred compensation – when and how should deferred compensation be used in order to align executives with appropriate risk-taking over the longer-term?

3 Remuneration governance – what changes are required to the governance of remuneration to ensure conflicts of interest are managed, and alignment with the firm's risk-appetite can be demonstrated?

Regulators, and in some cases governments, will apply significant scrutiny and challenge to these areas over the coming months and years. It is imperative for firms to devise a sufficient, yet proportionate, response to this challenge.

Incorporating risk into performance measures

Much of the discussion about risk-adjusted measures has focused on economic capital models, economic profit measures and the like. These are important. Firms should be working harder to cascade appropriate risk-adjusted measurement systems further down into the business, ideally to business unit level.

However, risk-adjusted measurement is more than just a formula. It is equally important that firms establish appropriate qualitative risk-based oversight of bonus pool determination, based on a dashboard of financial and non-financial risk measures. The role of discretionary judgement about quality of earnings – linking information about risk with information about compensation – is vital.

In part, this means understanding what risks are and are not covered by the risk-adjusted measures used in the business. Where risks are not captured (for example liquidity) then they should be priority areas for qualitative oversight.

Of critical importance, any mechanisms for determining reward will directly impact the culture of an organisation and frequently the unintended consequences are those that cause problems.

Deferred compensation

The future is unknown and future risk can never be captured perfectly in a measure of performance today. As a result, it is inevitable that a significant proportion of incentive compensation will in future be deferred in risk-taking areas of the business. We expect to see a majority of incentive compensation being paid in deferred form for high earners. The UK FSA has suggested as much as two-thirds.

Careful thought is required regarding the form of the deferral and the conditions of its forfeiture. The most common deferral vehicle has been group stock. For individuals within a particular business area, group stock is viewed as a remote entity, with value beyond their influence. By contrast, the value of their bonus is very much within their control. If they receive a bonus, part of which is deferred into stock, then for them the incentive remains to maximise the amount of stock they receive in the first place (by maximising their bonus), rather than to consider the impact of their actions on its subsequent value.

The conclusion is that deferrals need to be brought closer to the value of the business that generated the bonus in the first place. But how close? Our view is that the chosen level of the organisation for deferrals needs to strike the balance between creating individual accountability, and also supporting a partnership ethos. Striking this balance is the concern of regulators, and is reflected in some of the first-mover practice already seen in the market.

This will generally mean predominantly group deferral (using shares) for the group executive committee, a mixture of group and divisional-based deferral for divisional boards (perhaps achieved by a group long-term incentive award, combined with deferral of bonus into a divisional arrangement), and predominantly divisional deferral below that level. Use of business unit deferral arrangements might be appropriate in some circumstances, but there is a need to avoid fragmentation and the approach will be subject to challenges given ongoing business restructuring. Banks will also need to consider appropriate provisions for 'claw backs' where previously rewarded profit turns out to be overstated.

Consideration also needs to be given to the form of performance linkage within the deferred compensation arrangement. A plethora of possibilities exists: shares, divisional equity, bonus banks, 'toxic assets', subordinated debt, and so on.

For the behavioural impact to be maximised, the plan must be as simple as possible. Moreover, it is important to avoid unintended consequences that could arise from a 'bounce back' in depressed asset values. The nature of the performance linkage also needs to be considered: will the arrangement in effect be a 'clawback' based on deterioration in performance originated in the bonus year, or will the deferral be linked in a more general sense to the future performance of the business?

Governance

Perhaps the most profound changes to come from the current crisis will be changes to governance arrangements. This will extend beyond pay. However, governance in relation to pay is important in its own right. This is partly because, as much as the technical design of incentives, it is how pay systems are governed that influences behaviour. Also, how a firm is governed in relation to pay can be an observable signal of how its governance operates more widely.

We expect changes to remuneration governance to be profound. Pressure in relation to governance is coming from a number of areas including:

- Regulators who have been, or will be, putting forward views on good practice in relation to governance;
- Government support programmes, participation which is likely to involve requirements in relation to remuneration, reporting, and governance;
- Shareholders, who are increasingly focusing on the oversight applied by Remuneration Committees to remuneration, both at board level and below;
- 'The Triangle of Mistrust' between shareholders, remuneration committees, and management, which demands a more transparent and effective governance framework.

For institutions that will be under most scrutiny from the regulator on this issue, there will be a requirement to put in place a framework that enables the demonstration of good governance and independent oversight. The aim must be to achieve this at minimum cost and disruption to business management processes.

Regulators have announced that they will require some kind of annual report on remuneration practices throughout the firm, which could even extend to a certification from the remuneration committee chairman that the policies discourage excessive risk-taking and are robustly enforced. Such certification requirements are already falling on firms participating in second-round government support programmes in the US and the UK. It is likely that this will include an annual interview of the chairman of the remuneration committee at major banks on this statement.

These developments represent a significant extension of the remit of remuneration committees. Consideration needs to be given to how certifications of the type likely to be required will be supported. In our view this requires the governance arrangements covering pay more widely to be reviewed.

Firms need to review how a chain of oversight is constructed from remuneration committee into the divisions, to provide the necessary assurances of firm-wide remuneration policy. The review process for compensation will also need to encompass a much more significant role for the risk function, both in the design of compensation and its determination.

Management might view this as an unwelcome intrusion into their sphere of influence, so a pragmatic and workable structure needs to be developed, which meets the external requirements, while not limiting management's ability to use compensation as a performance driver in the business.

6.2 The talent tightrope

The next few years will involve a delicate balancing act on the part of banks, which must ensure that sufficient talent is in place to take advantage of the upturn, while keeping a lid on people costs during the period of economic difficulty.

People managers need to look, not only at talent within their existing business, but at developing the right kind of talent for the new one. The former stars of the banking industry are not necessarily the right people to carry the business forward in the future. Functions that carry a degree of oversight – risk, compliance, HR and treasury – will demand greater numbers of specialists, as will customer service. Conversely, as the appetite for complex financial products diminishes, so will the numbers working in these areas.

For universal banks there are major strategic questions to be asked about the extent to which, in a more highly regulated environment for pay, talent can be retained in the more exotic areas of investment banking activity, in the face of competition from boutiques and hedge funds.

The quicker future talent needs and costs are identified, the stronger the position banks will be in. Banks must however be careful not to slice out all their organisational experience: they will need experienced hands to help maximise the opportunities when the upturn arrives. At the same time, there is a need for new blood to save banks from group-think, which could pose a significant impediment to change.

6.3 A new deal for employment

Attracting Generation Y

The industry has suffered a reputation meltdown. Coupled with this, banks are no longer able to offer the same level of financial incentives. Banking has dropped sharply down the list of chosen industries for new graduates who previously clamoured to be let in.

Generation Y is entering the workforce with a very different set of motivations to its predecessors. This is a generation that better prioritises ethical concerns in its career choices, which makes banking, vilified as the instigator of the financial crisis, a potentially less than appealing choice of profession. Banks will have to think of new ways to attract good people as well as how to retain their high performers, who might be tempted by opportunities available in smaller boutiques, away from the glare of government intervention.

A new definition of what it means to be a banker

Financial institutions need to address their reputation and the social issue of what working as a banker means. The core messages presented by recruiters and marketers will have to change, as will the career profile. The perception of a ‘make money fast before you burn out’ culture is not relevant in the new long-term-focused, less financially lucrative era. Retail and commercial might be pushed to the fore as being attractive through offering greater stability and scope for customer engagement.

Creativity in managing the people costs

Organisations need to be creative in managing their people costs. Smarter strategies such as reduced working hours, career breaks, secondments or pay freezes could help to avoid the need for mass layoffs and prevent a talent exodus. A possible model for retaining access to talent is an extension of the consulting paradigm, in which people are not directly employed by the bank, but are available to be called upon to provide expertise when required.

Culture and the right behaviours

Simply debugging the failed reward models – although essential – will not by itself change anything culturally. Yet it is the culture of an organisation – rather than formal systems and processes – that ultimately ensures responsible risk-taking and organisational resilience. The enormity of the task in changing culture is one reason why it is often easier to focus on the cosmetic issues of compensation design. While not unimportant, compensation can never be the whole answer.

Successful banks will break out of the 'guns for hire' model, and develop a strong sense of what it means to be part of their organisation. This requires strong, values-driven leadership from the very top of the organisation, backed up by consequences – in terms of recognition, career development and, yes, compensation – that are consistent with the espoused culture. This can only be achieved over the medium term, but the journey needs to start now.

6.4 Conclusions

People, rewards and culture have played a significant role in the development of this crisis. Management should make it a priority to fix these issues, many of which will take significant time and effort to get right and will only deliver their full benefits in the long run.

Changes to reward systems and governance are the most urgent in the short-term, and are the focus of greatest public, government and regulator interest. Displaying a responsible approach to compensation will be an important part of reputation building for firms, and will also play an important role in bringing about change.

But compensation will only ever be a part of a change agenda. Financial services institutions need to build strong and resilient cultures in which responsible risk-taking, within the risk-appetite of the firm, simply becomes 'the way we do things around here'. This will require different approaches to reward, development, performance management, communications and recruitment.

Significant change will be required for financial services again to become the destination of choice of the brightest young graduates. Generation Y is entering the workforce with a very different set of motivations to their predecessors. It will take more than changes in compensation systems to attract them.

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