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Managing for performance

Transaction banking

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We are well aware of the erosion of public trust, constrained investor interest and evermore intrusive government intervention facing banks today.

We believe that by embracing a customer-centric business model and forensically managing performance through customer-informed value drivers, banks can win back investment and rebuild faith in their economic potential.

Managing for performance

The key question is no longer whether or even how transaction banking has been transformed, but how to re-engage with customers, how to respond to their changing needs and how to generate sufficient returns in this new business environment. In 'Managing for performance', we look at what different customers most value and how banks can make the most of the resulting opportunities and value potential.

Julian Wakeham
Partner, PwC

In our 2011 transaction banking overview ('Reshaping the vision: Emerging stronger from market transformation'), we looked at how the competitive landscape is being transformed by shifts in global trade, customer expectations, technology and regulation. We identified three key considerations for competing in this new landscape:

1. How do you get closer to your chosen customers – who will be your key customers in 2020 and how can you develop a more profitable relationship?
2. How will you manage risk and capital more effectively – what is the impact of regulation on your business model and how can you develop a more favourable and sustainable balance between risk and reward in this new environment?
3. How will you keep pace with market developments – what competitive advantages can you bring to bear and what resources and technology will be required to support this?

Our work with a range of global transaction banks highlights a further consideration that cuts across all those above – how to manage the business to optimise performance. The ways banks are going to have to do this are being transformed as quickly and decisively as the competitive and regulatory landscape in which they operate. 'Managing for performance' is therefore the main focus of our 2012 overview.

The starting point for managing for performance is the fundamental importance of a truly customer-centric culture and business model in ensuring survival and success in this new landscape. Strategies should be based on a deep and insightful understanding of customer needs. The challenge is how to keep pace with changing customer demands and make sure the organisation is focusing on the drivers that are going to make the most difference to performance and returns.

Our opening section looks at fresh approaches to enduring challenges including determining the right way forward for the business and dealing with the strategic implications of regulation, along with the return on equity expectations that underpin this.

In the second section we examine the changing needs of three core customer segments, namely small and medium size enterprises, large corporates and financial institutions, and how to gear performance management and organisational design to making sure the business can quickly respond to these evolving expectations.

In the final section we explore the unfolding opportunities for innovation and growth, with a key focus on how to make sure good ideas fulfil their potential by delivering real returns.

We are well aware of the erosion of public trust, constrained investor interest and evermore intrusive government intervention facing banks today. However, we believe that by embracing a customer-centric business model and forensically managing performance through customer-informed value drivers, banks can win back investment and rebuild faith in their economic potential.

I hope that you find 'Managing for performance' insightful and informative. Please do not hesitate to contact either me or any of the contributing authors if you would like to discuss any of the issues in more detail. We welcome your comments and queries.

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Section 1: A different approach to typical challenges

Article	*Brief synopsis*
ROE: the new equilibrium – finding a true measure of success	As many banks scale back non-core operations and seek out new sources of growth, what role does transaction banking play within this new banking 'equilibrium' and how should the value and returns of banks be judged? The remainder of this section challenges the way investment decisions are typically evaluated and considered.
Managing infrastructure for performance	High profile IT failures have shaken confidence in payments. How can banks rebuild market faith in their IT resilience and what part would more effective contractor management play in this? And how can these and other upgrades to infrastructure provide ways to capture key client data and bring customer profiling up to the standards being set in other industries?
Maximising return on regulatory investment	A wave of new regulation is creating huge implementation demands on banks. But these regulations could also accelerate market developments in areas ranging from electronic transfer to more competition in the settlements and clearing market. Smart banks are going to be looking at how to turn investment in compliance to their competitive advantage by using it to help serve customers more effectively.

ROE the new equilibrium – finding a true measure of success

As many banks scale back non-core operations and seek out new sources of growth, what role does transaction banking play within this new banking 'equilibrium' and how should the value and returns for the bank be judged?

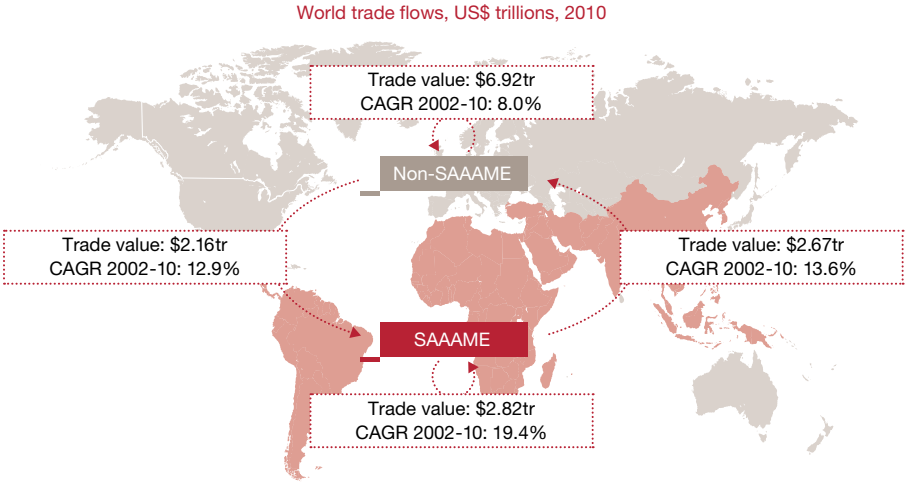
The banking market is being reshaped by the shifts in the economic landscape and customer needs. Further pressure for change is coming from governments and regulators' insistence that banks curtail their risks, scale back their balance sheets and provide more support for the 'real' economy. Many banks' response includes a closer focus on transaction banking opportunities. But as we explore in this article, the verdict is still out on how successful they can be and a change of tack may be needed.

If we begin by examining how groups as a whole are responding to this new economic and regulatory landscape we can see a mixed bag of sound, disciplined business adjustments and messy reactions to short-term regulatory imperatives. Worse still are the potentially damaging decisions stemming from misguided efforts to reduce risk-weighted assets (RWA) and boost return on equity (RoE) – 12%-15% is the typical target. The assets being relinquished in the drive to cut RWA may actually be the businesses that offer the greatest long-term potential if retained. In turn, these RoE targets may be unrealistic given the state of many developed economies and the absence of the leverage that did so much to boost RoE before the crisis. Nonetheless, many banks believe that a mid-teen RoE is needed to attract and retain the levels of equity that regulators are demanding.

So where does transaction banking fit into this shake-up? In many ways, the need to re-balance risk and reward and re-engage with the real economy plays to transaction banking's strengths. Transaction banking has always offered a strong and stable source of relatively low risk and capital light revenues.

Transaction banking's strategic importance is being reinforced by the shift in the focus of investment and growth towards the fast growth markets of South America, Asia, Africa and the Middle East (together these markets form what PwC terms as 'SAAAME'). It is not just the growth in these economies but the increasing trade flows between them that are going to be so crucial to business development by both banks and their corporate customers (see Figure 1.1). Banks that can develop the geographical reach and service capabilities needed to follow their clients into new markets and tap into these trade flows would be in the strongest position to attract and retain customers and develop new sources of revenue. While some banks are looking to exit from markets that do not meet their immediate RoE targets on a standalone basis, others are seeking to extend their international coverage in recognition of its importance in sustaining client relationships and enhancing performance.

Figure 1.1 Transformation in global trade flows



Source: PwC

But transaction banking is not a magic bullet. First, using transaction banking to improve group RoE does not necessarily address wider problems in the group and does not consider whether the existing client franchise supports the business that the bank is trying to develop. From a group perspective, it is important not to lose sight of the portfolio perspective and understand where transaction banking fits within the broader product portfolio. The related question explored in this article is whether ROE is necessarily the most appropriate criterion upon which to make business decisions as it may not reflect the underlying business performance and real economic value of the business. The second challenge for transaction banking development is that there may be insufficient scale in the new target markets to provide adequate volumes and margins for all the institutions that want to enter. Finally, transaction banking is a very different business from traditional wholesale banking and the management skills, capabilities and expertise of the existing management team may not be appropriate to support this move into new markets.

These issues have been brought to the fore because some banks may be stepping up their focus on transaction banking for what might be described as the 'wrong' reasons. In particular, they may be favouring transaction banking simply because it is less capital intensive than their potentially more volatile lending and trading counterparts rather than judging business development on the relative commercial opportunities and their ability to capitalise on them. Many areas of the transaction banking marketplace may become more crowded as banks rush to expand, with SAAAME markets likely to be a key target. Too many banks chasing too little business is likely to drive down prices and margins and offset any advantage from the lower capital costs of this business. As outlined earlier, senior management may also lack the necessary experience to steer such a rapid expansion in transaction banking. Favouring transaction banking simply because it makes sense from an RWA optimisation perspective is thus a clear case of the regulatory tail wagging the strategic dog.

Realistic expectations

So how can banks shape their transaction banking and wider business support services to make the most of its potential within the new risk, capital and market equilibrium?

While in the past, transaction mandates tended to be offered as the prize for finance, helping clients to move into unfamiliar and often under-developed markets is likely to require a more symbiotic relationship between lending and transaction services. This might include finance to help clients set up manufacturing facilities in a frontier SAAAME market and then support for the infrastructure and other developments needed to build up demand in local markets.

While the reward potential would mirror the strong GDP growth in the SAAAME economies, contending with varied and possibly limited risk data, legal systems and regulatory frameworks could radically change the risk profile of your business. Loans may be riskier. The need to operate with an ever growing array of local partners on the ground would also heighten counterparty risks.

Banks are therefore going to need new ways to price and mitigate their exposures in these markets. Prices will be affected by higher risk, capital and funding costs. But this will be partially offset by product rationalisation and lower operational costs. Areas where the high capital costs are matched by high levels of customer demand are likely to be the greatest focus of innovation and re-engineering.

Banks may also need to look beyond RoE targets at more relevant measures of performance and success for these longer term and relatively high risk and reward strategic plays. Risk-adjusted measures such as economic profit would provide a better indication of the true value being created across the different operations.

The underlying challenge is how to convey the rationale of these strategies to investors and whether they would accept the implications for RoE. Some may withdraw their investment if their RoE expectations are not met. But on other measures the long-term potential of banks that can tap into fast growing economies and trade flows will be strong. RoE measures may also be less universally comparable as a result of variations in gearing and local capital requirements, leading to greater focus on economic spreads and profitability.

The new equilibrium

Far from being a cyclical downturn, the market and regulatory forces shaping the banking sector are here to stay. The good news is that the fundamental customer need for banking products and services has not disappeared, and the opportunity in the long run to service that need profitably has not gone away either. A new equilibrium is thus set to emerge over the next three to five years as de-leveraging runs its course and banking moves closer to the real economy in both its service offering and return expectations.

Transaction banking is at the forefront of the renewed focus on the real economy. But it could also take banks into riskier and more volatile markets that are out of step with the current mantra of RWA optimisation and demand to boost RoE in the short-term. Such moves may also be beyond the scope of existing management expertise. We therefore think it is crucial that banks recalibrate their economic models, performance targets and pricing formulas to the new economic realities. They also need to make sure that they have the capabilities and differentiated strategies to make sure that transaction banking realises its return potential.

As with any change, there will be relative winners and losers. The winners will be those that manage through this transition most effectively and emerge in the new equilibrium with their franchises and balance sheets in best shape. In a nutshell, there is everything to play for.

If transaction banking may be one of the beneficiaries of the new funding and strategic considerations facing banking groups, it is also facing significant new regulation of its own. At the heart of these changes is the pressure to strengthen and update payments and custody systems. As we explore in the remaining articles in this section, smart banks are looking at how they can use these regulatory demands and the necessary investment this entails as an opportunity to develop new markets and improve customer experience.

Banks need to consider looking beyond RoE targets at more relevant measures of performance and success, such as risk-adjusted measures such as economic profit which would provide a better indication of true value being created across the different operations.

Managing infrastructure for performance

High profile IT failures have shaken confidence in payments. How can banks rebuild market faith in their IT resilience and what part would more effective contractor management play in this? At the same time, banks are missing out on a commercial opportunity as they are finding it difficult to draw any insight from all the transactions in the system. So if infrastructure investments have to be made, how can they be turned into a source of competitive differentiation by providing ways to capture key client data and bring customer profiling up to the standards being set in other industries?

IT resilience within the banking sector was once taken for granted, with customers and regulators seeing this as a well-funded, well-managed and highly robust area. But confidence is now sagging. CIOs face two pressing priorities, namely how to understand and manage the risks of their existing IT infrastructure (including the outsourced components) and how to make sure the required investment delivers maximum value (for the customer franchise and for shareholders). This article explores dependency risks, including vendor and contractor management, system complexity and the relationship between reducing complexity and managing risk and extracting value from the IT infrastructure to benefit the end customer and organisation.

So why is payments infrastructure now in the spotlight? This is a vital part of the economic fabric. Yet in many countries, this delicate ecosystem is in a fragile state as it seeks to contend with the strains of age, under-investment and increasing demands (e.g. faster payments, SEPA etc.). Piecemeal upgrades, connecting with other systems following mergers and use of third party suppliers have created complex 'spaghetti-like' mechanisms that are expensive to manage and maintain and only completely under-stood by a small number of key staff. These problems are compounded by the fact that many banks have shifted their investment focus away from maintaining IT resilience to other programmes of work as they have expanded, merged and sought to offer new services.

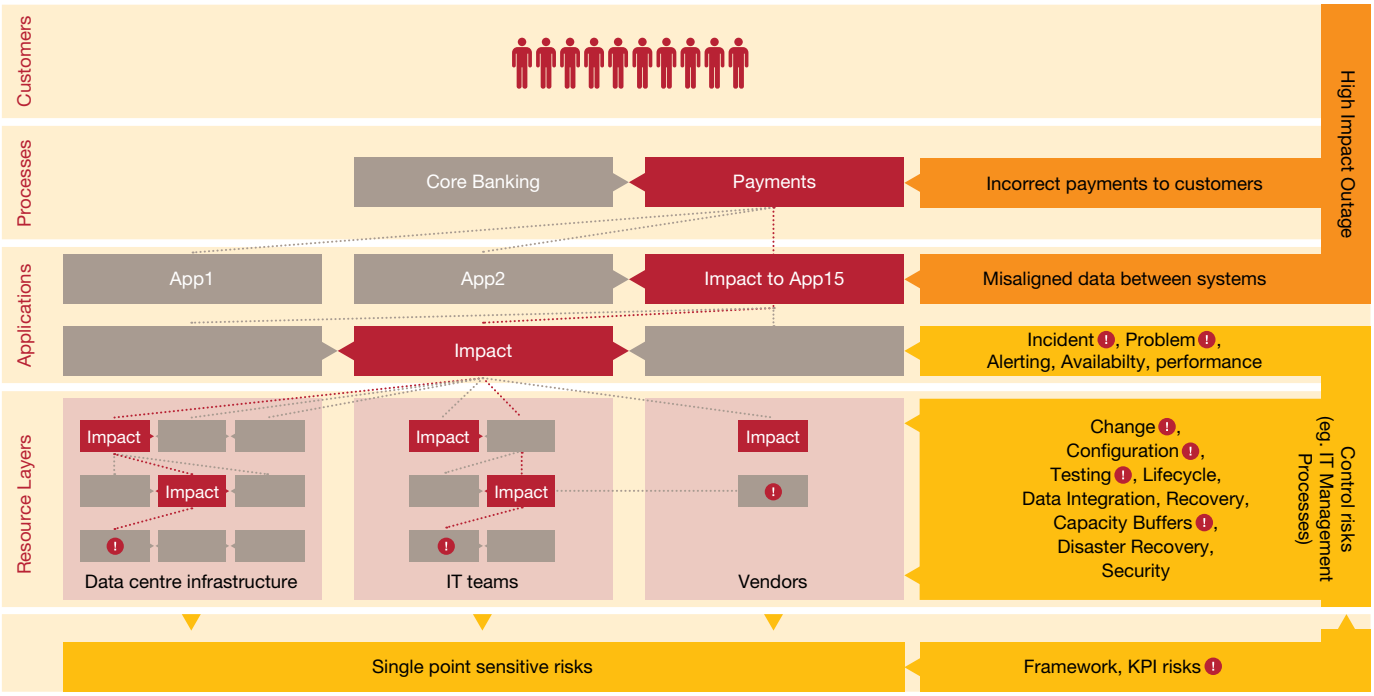
Complexity is compounded by limited understanding of the complete IT landscape, which makes it harder to gain a clear view of the impact of IT changes. This lack of visibility prevents the development of effective IT resilience solutions, allows single points of failure to creep into services and contributes to IT service outage as the impact of changes cannot be fully assessed. Further tensions are coming from the ever increasing pressure to deliver more IT changes faster.

The pressure of demand is also growing. This includes increases in real-time (or near real-time) data transfers between IT systems, combined with a reduction in buffer capacity (from data growth). This pressure can create data concurrency risks, which are highly sensitive to changes in business rules, IT interfaces and IT failure events. Assessing these changes requires both business and IT analysts to appraise and approve modifications and upgrades.

These weaknesses have led to an increasing number of high profile incidents that affect customers and are embarrassing for the banks concerned. The risk of breakdown is a growing concern for financial regulators around the world and has put resilience squarely back on the agenda. As a result, some banks are actively reviewing their IT services and the controls around them in anticipation of increased focus from customers, regulators and investors.

The risks surrounding payments highlight the broader IT issues. Complexity is of course, unavoidable in any global payment system as these typically support multiple mechanisms, products and customers.

Figure 1.2 Dependency risks



Source: PwC

Managing IT dependency risks

The immediate challenge is how to identify and tackle weaknesses. At present, risk management frameworks do not always provide management with accurate or telling information. This makes it harder to identify and tackle IT risks.

One of the most difficult challenges is how to take account of the impact of multiple dependencies. Figure 1.2 highlights common dependency risks. These risks can coalesce to cause high impact failures in business critical processes. A minor change or problem in one infrastructure component can have a severe knock on impact if it impinges on additional weaknesses in IT controls and IT risk management further down the line. While third party specialists can provide innovative and insightful solutions, their presence can add to complexities and interdependencies within the IT infrastructure, making the management of vendors and contractors a key area for risk management focus.

Before considering what is needed to limit contractor/vendor dependency risks, it is important to map the bank's core payment infrastructure (engine, gateway and sanctions checker) to their end-to-end payment flow.

The bank can then gain a clearer picture of the critical nature of their peripheral systems and processes (e.g. channels, bulk splitters, payment warehouses, XML converters). Only then can the appropriate type and level of contractor/vendor management be applied. Ways of strengthening resilience might include bringing vendor staff and operations within the organisation rather than outsourcing critical processes. Another option would be implementing end-to-end monitoring systems and clear remediation plans that would allow appropriately skilled bank staff to regain control quickly if necessary.

Banks will also need to focus on how to anticipate and review potential risks, how strong are their levers of control and how they are being operated as part of overall IT resilience management. We have carried out a study of practices adopted by major organisations across a range of sectors and identified three key categories of practices, with nine organising principles for managing vendors and contractors (see Figure 1.3). These translate into seven key drivers for managing successful vendor relationships.

Figure 1.3 Organising principles used in understanding the vendor/contractor management relationship

Establishing and maintaining relationships	*1* Common targets	*2* Nature of relationship	*3* Mutually sustainable outcomes
Implementing levers of controls and influence	*4* Relationship management	*5* Risk & control	*6* Responsibility & accountability
Making it work	*7* Planning & responsiveness to unplanned events	*8* Resources: capability, capacity & flexibility	*9* Performance management

Source: PwC

At the heart of this framework is the need for more co-ordinated purchasing and consistency in the management and review of third-party services. Streamlining vendor services is also crucial as an excess of suppliers is difficult to manage. Underpinning this is the need for high level sponsorship to make sure the resilience of third-party systems is a sufficient priority within the bank and recognised as critical to the relationship and resulting revenues by the supplier.

Reducing complexity

The critical nature of payment systems mean that banks often replace elements of their IT infrastructure with vendor solutions in a piecemeal way. They may even decide part way through implementation to keep particular parts of the legacy system to deal with bespoke processes. This approach exacerbates the fragmented understanding of the complete landscape. Layers of complexity are added when legacy systems are excluded from improvement programmes to help speed up delivery and reduce cost.

Unfortunately this complexity means that as banks look at how to strengthen confidence in payments and gear systems to increasing demands, the point at which it is easy to address these problems has passed. On-going upgrades and maintenance to the infrastructure are expensive and only achieve a preservation of the status quo. The effort of meeting new regulatory requirements, which continue to emerge, needs to be increasingly manual as systems struggle to keep up, further inflating costs. Investment is therefore vital.

The alternatives to a multi-year improvement programme – e.g. hosted service provision, joint venture to deliver payments infrastructure, full transaction outsourcing – are used by some of the smaller banks. But these are not seen as a viable solution for their larger counterparts. A shift from tactical to strategic investment is therefore required to put payments infrastructure onto a sustainable footing.

Figure 1.4 Key drivers for managing successful vendor relationships in a composite model of excellence

Number of contractors	12 or less per business Less than 4 per high impact category	Difficult to maintain deep working relationships with too many contractors and will spread staff too thinly	Bank needs to manage contractor development programme consistently over time Relationship needs high level executive sponsorship, clear targets, retained multi-functional team and time to drive the relationship
Relationship length (not contract length)	10 years +	Takes time to translate corporate intent into ways of working	Contractor needs to hear the same message from the bank regardless of where across different levels relationship sari held
Impact on supplier business (actual or intended)	Within top 5	To ensure appropriate level of influence to get the right resources and investment can be applied	Prevent maverick or non-compliant purchases through consistent internal messaging
Sourcing type	Sole but not single source	Retain alternatives to reduce risk, but provide contractor with sufficient commercial certainty to forecast likely demand	Contractor aware of wider commitment as a result of sole sourcing, but aware of consequences for underperformance
Invasiveness of inspection / audit / assessments	Highly invasive and rigorous	To enable informed benchmarking and ensure commitments are complied with. To establish message that verification will follow trust	Bank needs to view the audits as a business asset – dependent on leadership commitment and ability to execute
Training, systems, standards and reporting	Mandated by bank with some shared IT platforms. Reporting and data integrity built into contractual requirements and operational ways of working	Consistent way of working to reduce uncertainty and promote efficiencies over time	Banks need to demonstrate compliance with their own standards – demonstrating to vendors that they will follow their own rules and standards and non-compliance will not be allowed
Common industry standards	Banking typically benefits from a high level of regulation and standard setting – however implementation and execution of the standards may vary across banks. Not all vendors may be subject to the same level of regulation	Helps level the playing field in terms of cost of compliance	

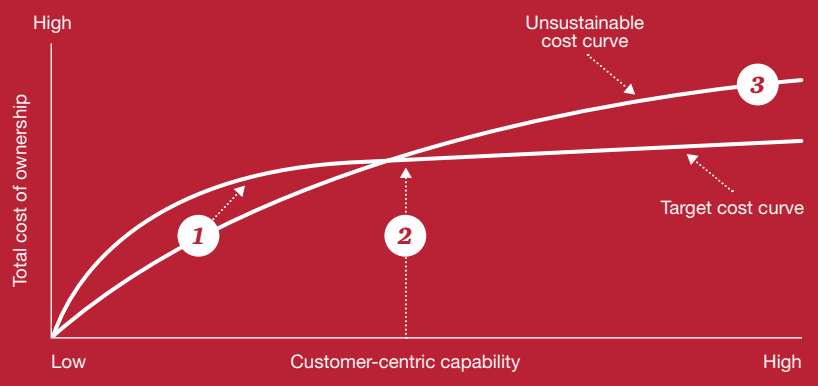
Source: PwC

Winning CIOs enable the business capabilities needed to achieve customer centricity at a lower cost – by investing in a scalable and robust technology environment

Just being customer-centric is not a sustainable competitive advantage, because any organisation can become customer-centric. The real differentiator is enabling customer-centric capabilities faster and more cost-effectively than your competitors.

Growing the business without increasing costs faster than revenue may be a challenge if the institution's technology foundation is not flexible. Establishing foundational capabilities – such as a flexible architecture and single view of the customer – allows for the extension of IT capabilities to enable new, customer-centric business capabilities while still maintaining profits.

Figure 1.5 Technology investments are needed to move organisations to a lower target cost curve and enable greater customer-centric capabilities at a competitive cost



1. In order to move to the target cost curve, leading organisations make strategic investments in a flexible architecture and robust technology foundation. These investments pay dividends in the longer-term, even though tactical investments may present quicker and cheaper options in the short term.
2. An inflection point occurs where investments in foundational capabilities begin to pay dividends. Additional customer-centric capabilities may be delivered while maintaining margins.
3. Without the early investment, an inflexible architecture and "waxy build-up" within the technology stack put organisations on an unsustainable cost curve, eventually making it cost-prohibitive to deliver additional customer-centric capabilities.

Source: PwC March 22, 2012, FSViewpoints: If They're Happy, Do You Know It? - The CIO's Agenda in Improving Customer Centricity at Financial Institutions

Whether banks want to overhaul their payment infrastructure or need to take a more pragmatic incremental approach, they need to approach the challenge with the same objectives: Simplification and transparency to address the complexity challenge.

Leading banks are seeking to simplify their systems in a systematic and consistent way across the whole of the payment infrastructure. This approach is equally beneficial whether the existing systems are being gradually upgraded or completely replaced. The advantages include increased flexibility and sustainability as the environment becomes easier to understand and cheaper to change and manage. It is time to consider the presence of all bolt-on functionality layered on over the years and ask: 'Is it still needed?' Where a feature remains critical it should obviously be preserved. Where there are multiple features doing broadly the same thing in slightly different ways, the simplest should be preserved and the others standardised. If the original reasons for a feature are no longer valid, it should be discarded as soon as possible.

Simplification and transparency are key objectives to addressing the complexity of IT change. Central to any change is the ability to develop more customer centric IT infrastructure.

Figure 1.6 Focusing technology on customer needs

A proper technology foundation and basic, customer-service-enabling capabilities have become table stakes in the financial services industry. Getting ahead of the curve means going beyond traditional IT capabilities.

How well is your technology enabling a customer-centric business?

Business information

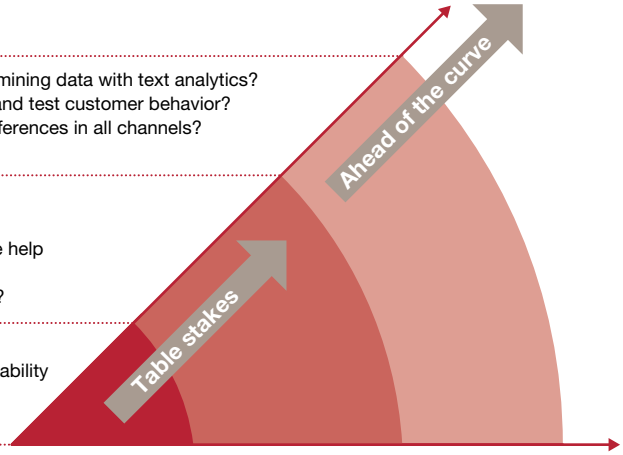
- Can you track customer sentiment online by being engaged in social media and mining data with text analytics?
- Do you have advanced analytics and predictive modeling capabilities to predict and test customer behavior?
- Do customer-facing employees have access to all customer interactions and preferences in all channels?
- Are customers segmented beyond demographics?

Technology solutions

- Does your technology landscape support multi-channel integration?
- Is there a true single view of the customer across all business units?
- Can customers customise their Web Portal experience and have access to online help with rich functionality, and click to-chat?
- Is mobile access for customers and employees enabling a better service experience?

IT operating model

- Are your management decision cycles bogged down in bureaucracy?
- Do legacy IT systems create an overly complex IT environment that prevents capability delivery in a timely manner or at a reasonable cost?
- Are all employees offered incentives to drive customer satisfaction results?



Source: PwC March 22, 2012, FSViewpoints: If They're Happy, Do You Know It? - The CIO's Agenda in Improving Customer Centricity at Financial Institutions

Smart use of data is critical to managing for performance – getting closer to customers and enhancing revenues – while reducing the burden of complying with regulations. Legacy payment ecosystems often capture the bare minimum amount of information required to execute a payment and are not structured in a way to support greater transparency of underlying data. It is then difficult to develop an aggregate view across all payments to spot trends and develop a comprehensive, customer centric view of payments transactions. This is a lost opportunity to enhance insight and generate cross-selling opportunities in areas such as hedging and working capital management.

When investing in payment infrastructure, planning to enrich the data capture and processing capabilities to allow for greater transparency should be a key strategic aim. This will be extremely difficult for some legacy platforms, and will need to be delivered incrementally. Delivered strategically, the investment will yield broad reaching benefits.

Extracting value for the end customer and organisation

From a competitive perspective, bank payments are at risk of becoming a commodity service that smarter companies use to their advantage (see Figure 1.6). Retailers are offering an ever wider range of banking products to consumers, using their expertise in customer insight and analytics to plan market entry, target customers and maximise the chances of success[7]. Figure 1.7 highlights how banks can address the key IT issues from a customer-centric perspective.

7. http://www.guardian.co.uk/money/2012/jul/18/marks-spencer-bank-current-account

Moreover, technology companies are using their IT skills and brands to position themselves between the banks and consumers to gain control of that crucial, and lucrative, relationship[8]. Although currently mainly a threat to consumer banking services, emerging payment hubs and supply chain collaboration through multinational company portals offer opportunities to augment corporate client services and relationships. These would provide the insights banks need to regain the competitive initiative from the new entrants.

A platform for innovation

So if sustaining payments infrastructure is a challenge for many banks, it is also a competitive opportunity for those that put simplicity, transparency and customer insight at the top of their investment agenda. The result will be a more flexible and controllable platform, which will be better able to meet changing regulatory requirements and ensure that banks can respond to evolving customer expectations with confidence.

Figure 1.7 Addressing the key issues from a customer-centric perspective

Issues to address	Technology implications
Legacy systems (waxy buildup)	Application rationalisation and a move towards a service-oriented architecture are 1) required to keep pace with the technological change that is necessary to respond to customer needs. 2) reduce time-to-market for new products, and 3) reduce operating costs in order to divert funds to discretionary spend that can be used to please the customer.
Single view of the customer	Achieving a single view of the customer requires a single source of truth for each piece of customer data, which can then be integrated and utilised, preferably as a service, by all applications that use and update customer information. Proper data architecture and governance are necessary to maintain the integrity of all customer integration. A comprehensive information strategy may pave the way.
Integrated multi-channel	All channels should be able to access the information contained in the single view of the customer in a way that ultimately presents customer data to end users in a consistent format. Updates across channels should automatically update the master customer record and be architected so that inconsistencies cannot be created in the record by utilising master data management.
Customer segmentation	Analytical capabilities to segment customers beyond traditional techniques should be in a place. Understanding individual customers' decision processess, behavioral characteristics, and likelihood to buy are all paramount to effectively managing the consumer base and providing tailored customer experience.
Data security	Recent data security breaches at several institutions have had severe consequences in terms of customer satisfaction. Sensitive information is exposed, existing customer confidence is shaken, while potential customers who question a company's ability to keep their information private are likely to look elsewhere for products and services.

Source: PwC

8. http://www.finextra.com/News/Fullstory.aspx?newsitemid=24062

Maximising return on regulatory investment

A wave of new payments and securities regulation is creating huge implementation demands on banks. But these regulations could also accelerate market developments in areas ranging from electronic transfer to more competition in the settlements market and new business models in the custody market. Smart banks are going to be looking at how to turn investment in compliance to their competitive advantage by using it to help serve customers more effectively.

Governments and regulators have set their sights on banks as they seek to take a stronger grip on potential systemic risk and make it easier, cheaper and quicker for businesses and consumers to transfer money domestically and internationally. A further priority is how to make economically vital payments infrastructure safer and more secure. Similarly, new regulation is putting pressure on existing infrastructure, operations and business models within the custody market.

As we outline in this article, we believe there are two key principles to consider when addressing regulatory change:

1. Approach regulatory change holistically to avoid duplication and unnecessary costs, and
2. Keep customer needs and improved customer service at the heart of all change efforts to deliver value beyond pure compliance.

Holistic approach

For many banks, simply getting over the regulatory implementation line is the main priority. But a reactive approach that addresses each new regulation in isolation can be needlessly costly and disruptive. It could also be operationally unsustainable given the cumulative scale of the changes. So we believe that it is important to look at the developments in the round to avoid duplication and unnecessary costs.

Using this holistic approach to the evaluation and implementation of new regulations as the starting point, Figure 1.8 outlines some of the key considerations for budgets, business model evaluation and regulatory lobbying in the payments field. Banks are going to have to make a considerable amount of investment to meet the new compliance demands, so making sure the new systems and capabilities can be channelled into meeting customer demands and developing new markets is going to be the most effective use of resources.

Figure 1.8 Deal with regulation holistically

Budget

- The biggest use of budget for the next 3-5 years
- Efficiency – "Do it once"
- Timings
- Align with other ongoing projects

Influencing regulators

- Understanding the impacts in sufficient detail to lobby in the right areas, in the right way, and at the right time
- Ensuring group and individual business line impacts and lobbying views are appropriately aligned globally

Identifying future business model

- With large scale reforms re-shaping the market, firms are looking to ensure they are well placed both operationally and commercially as regulations come into force
- Ensuring the firm's business model is sustainable and tailored to take account of the changing market

Ensure on-time compliance

- Pricing is affected e.g. pricing models for Euro Banking Association (EBA) versus Target 2 in the Eurozone or faster payments versus CHAPS in the UK
- Parts of the business are front-running others with respect to regulatory response
- Senior management discomfort over extent of change and internal responses

Source: PwC

Figure 1.9 Identifying and capitalising on the opportunities

Assess	Design	Construct	Implement	Operate and Review
Assess current approaches to regulation and impacts of regulation on the business	Determine governance approach	Design your approach to the changes	Execute projects and make strategic decisions	Maintain focus on reforms in BAU
• Meetings with the business and support functions to understand how regulation is currently approached • Creation of a 'regulatory inventory' covering the reforms impacting the firm's businesses • Assessment of the impact of these regulations on the business and support functions	• Gaining a view of: - committee structures, - working groups, - current projects, - key stakeholders • Determining the appropriate governance model to 'fit' within the firm's current structure • Formalising a sustainable decision making framework • Identifying resources to deliver the structure	• Based on the outcomes of the heat-maps, designing a thematic approach to the regulations • This approach allows similar changes to be made together • By approaching regulation on a theme basis, there is reduced risk of duplication of effort, and ensures changes are made efficiently	• Creation of project initiation documents to provide a basis for delivery • Execution of projects • Project reporting into the steering committee allows options to be considered and strategic decisions to be made	• Delivery of governance and projects in a business as usual environment • Ensuring the approach to regulatory change remains proportionate over time, scaling projects up/down based on regulatory timelines and priorities • Providing the business with the capability to review upcoming regulation and integrate them into BAU

Source: PwC

As we explored in the previous article, most payment systems have been built up over time, creating a highly complex and poorly understood business and technological infrastructure. While investment is needed to meet new requirements such as SEPA and address regulatory concerns over IT resilience, it can also be channelled into improving customer insight and experience. As Figure 1.9 highlights, a key foundation for the impact evaluation of new regulation and subsequent response is therefore mapping the end-to-end payment flows, segmented by payment product and customer type (retail, corporate and investment bank). This will provide the foundation for an opportunity assessment and aligning investment in new systems and capabilities with the performance drivers within managing for performance.

Dealing with market transformation and divergent customer needs

In some cases, the sheer volume of new regulation is fundamentally changing the market and it may not be enough to simply address regulation holistically. Payments and custody (as illustrated by Figures 1.10 and 1.11 respectively) are good examples of areas experiencing significant and market-changing regulation. Designing change to address regulatory compliance requirements based on the commercial imperatives of the old market runs the risk of building a business that is completely unsuited to the competitive requirements of the new landscape. In such cases, banks will need to look at which customers they want to serve and how, taking into consideration scale, customer needs and likely returns. For many, the results of this evaluation are likely to lead to a fundamental shift in the business model for custody business (the impact of new regulation in the FI market is further explored in the 'Understanding customer needs' section).

Strengthening customer service

In addition to considering change holistically, it is also important to keep customer needs and improved customer service at the heart of all changes. This will allow banks to gain the competitive payback from their investment in compliance.

Figure 1.10 Key regulatory changes in the payments space and implications for banks

New regulations will have competitive as well as operational implications and will need to form a key part of strategic evaluation and planning. This includes identifying the opportunities.

Regulatory aim	Force / Regulation	Implications for banks
Speed up payments Directive (PSD)/ Single European Payments Area (SEPA)	Payment Services (Faster Payment Service in UK)	Next day and same day transfer
Make cross-border payments easier and cheaper	PSD/SEPA	Pressure on costs of transfer/ Greater cross-border standardisation
Open up market by allowing e-money providers to offer payment services	E-Money Directive	Advance mobile payments/ digital wallets
Promote greater competition	SEPA Account Switching Solution in UK	More non-bank entrants/ Pressure on costs of transfer
Simpler account switching	Account Switching Solution in UK	Switch within seven days/ Guaranteed re-direction of payments/£650–£850 million investment[9]
Ring-fence payments	Recovery and resolution plans Higher operational costs Financial Stability	Operational separation between retail and investment arms/ ('living wills')/Board G-SIFIs/ Independent Commission on Banking (ICB) in UK
Control systemic risk Payment and Settlement Systems	Basel Committee on the risks of high value tiered payments systems (examples include CHAPS in the UK)/ Encourage large indirect participants to become direct participants	Identify, manage and control
Bolster tax revenues possible interruption and alteration of payments inflight	EU Financial US Financial Account Tax Compliance Act (FATCA)	Greater scrutiny leading to possible

Source: PwC

9. Payments Council media release, 15.09.11

Figure 1.11 Key regulatory changes in the custody and clearing space and implications for banks

Force / Regulation	Description of impact	Likely Scenarios	Implications for banks
T2S	• T2S is a settlement platform being built and owned by the ECB (European Central Bank) • Due to go live in Sept 2014 • Unifies settlement across countries	• T2S will happen but not be mandatory • It may be late due to technical and non-technical reasons • It will unify settlement, but corporate actions, dividends and tax will be less harmonised due to contracts/legal differences in differences in issuing countries	• A number of institutions are actively involved in moving the project forward • Some European competition looking at providing T2S solutions to clients • Others just beginning to consider the issue at all • Not all are convinced of the value T2S will add
Exchange consolidation	• LSE / TX Merger February 2011 • DB / NYSE proposed merger announced March 2011	• NYSE/DB merger will proceed and include Clearstream (50:50 chance)	• Not currently seen as a major issue. This may change once greater clarity emerges
CSD competition and consolidation	• Increasing downward pressure on revenue which may be accelerated by T2S • Additional expenses to be incurred, connecting to T2S • Positioning further up the value chain	• ICSD agency outsourcing for notary function on issuer services is likely to stop • Continued migration of international issues from ICSDs to CSDs	• Leading players see the benefit in becoming a CSD • Acquisitions not being widely considered
Increased need for collateral	• Increased regulatory requirement for Collateral as transactions move on exchange • High quality collateral likely to be in short supply leading to: - Transformation - Immobilisation - Globalisation	• Independent central bank liquidity arrangements will cease (i.e. the end of cheap money) • Banks are looking to collateral services to compensate for a decline in OTC derivative revenue • Potential for business to migrate to Europe post July 2011 and prior to the implementation of EMIR	• All included in the sample have identified this area as an opportunity and client need • Broker dealer community most advanced and have the most to gain • Wider recognition that for most institutions, existing technology and silo organisational structures not fit for purpose • A few institutions are looking at establishing direct custody presence in selected markets. Most, however, will continue to rely on an agent network

Source: PwC

A clear case in point is the shift to a single cross-border payment network[10], which will provide companies with an opportunity to consolidate their invoicing and collections onto a single platform. For banks, this is an opportunity to provide clients with more integrated and real-time information. Banks that are geared up to supporting their clients in centralising collections and channelling the funds will also benefit from a significant upturn in transaction flows. Further opportunities include the promotion of contactless and mobile payments as part of the E-Money Directive, which has helped to accelerate the development of what Eric Schmidt, Chairman of Google, believes will be a 'trillion dollar' industry of mobile payments and advertising[11]. Businesses are now following the retail market in looking to take advantage of the ease of mobile payment. Again, banks can use this as an opportunity to collect and analyse data, both for their own needs and to provide insights for their customers.

Coming through stronger

Regulation is spurring a lot of market change and development quite aside from the direct compliance requirements. A properly co-ordinated and strategically-aligned approach to the new regulations would help banks to take advantage of the commercial opportunities opened up by these developments.

10. Single European Payments Area (SEPA) direct debit requirements are being introduced. By February 2014, domestic transactions within the Eurozone will need to move over to an International Bank Account Number (IBAN) based system. The UK is due to follow by 2017.
11. Financial Times, 22.06.11.

Section 2: A model for performance management

Article	*Brief synopsis*
Performance management: getting straight to what matters	Many transaction banks are suffering from too much information and too little focus. We believe focusing on the right balance of important performance drivers and recognising the critical role behaviour plays are the key to managing performance. Core drivers in the areas of operational efficiency, value and control are explored in more detail. We also consider the impact of different organisational structures on performance management and behaviours and opportunities for increasing revenues.
Understanding customer needs	Sources of value differ significantly by segment. We explore the emerging needs of key segments: changing SME expectations and the impact of the digital tipping point; the multiple buying points emerging from credit disintermediation in the corporate segment and the evolving business models and pricing structures emerging in the financial institutions segment.

Performance management: getting straight to what matters

At a time when banks are facing a raft of new regulations and changes in customer demand, transaction banking activities could make a significant difference to returns. One of the keys to fulfilling this potential is a more streamlined and coordinated approach to identifying and pulling the key performance levers of the business.

Transaction banks are constantly under pressure to cut costs and boost revenues. But performance often suffers from a lack of clarity and precision in what actually creates value and how these drivers can be managed to meet cost and revenue targets. What banks are missing out on could have a significant impact on group returns. By way of illustration, for one client, effective performance management of the transaction bank has the potential to generate up to a 16% increase in group revenues and an 8–10% reduction in group operating costs.[1]

So why are banks finding it difficult to manage for performance? It is not that banks lack information. The problem is stripping this down to what really matters – the small but decisive set of drivers that deliver value and the levers that influence the value. This includes what customers value, the processes needed to meet their needs and the behaviour and incentives within the organisation, which that optimise performance. It is our view that better alignment with customer value will also result in improved commercial/shareholder returns.

Framework for performance management

Leading banks are developing sharper ways to define value and improve performance. This approach is built around the clearer identification of the key performance drivers and alignment of these with the strategic processes and critical behaviours needed to deliver value.

What are the key performance drivers?

We define an effective performance driver as something that:

- has a meaningful influence over a situation
- is measurable
- management has a degree of control over, i.e. that management can do something about.

These performance drivers or levers can be influenced by management to enhance performance and profitability, be this reduced cost or increased revenue. This could range from insights into client needs and how effectively these have been met, to the efficient use of staff time or the level of standardisation and automation in a particular process.

1. PwC Analysis of company accounts

Figure 2.1 Performance drivers can be identified through various lenses – there are pros and cons of each

	Performance drivers	Metrics	Examples of performance drivers
Product revenue and cost drivers Highlights the key synergies between products in terms of revenue and cost components	Unlocks an understanding of the underlying drivers of value or product performance, i.e. the underlying drivers of cost and revenue, e.g. SLAs, process efficiency, service, etc.	Contributed key revenue and cost metrics and highlighted metrics related to underlying drivers (e.g. efficiency metrics, service quality, etc.) and the importance of synergies across products	• Cost by type and process • Time to market • Level of value-added pricing • Standardisation • Innovation score • STP • Product penetration
Customer (including sector and segment) drivers Illuminates the key drivers of client need across different sectors and segments to inform solution development	Highlights the importance of taking a client-centric perspective to understanding value, i.e. understanding client, market, competitors – the external environment	Informs key metrics – particularly those focused on product development and service and operations to ensure a client-centric measurement of performance	• Customer share of wallet • Engagement score • Customer retention levels and customer drift • Trusted adviser status • Customer profitability
Strategic processes across business dimensions Provides a detailed view of performance drivers across different dimensions of the business – highlighting the importance of cross-functional cooperation	Identifies detailed performance drivers across business dimensions – these were grouped across the strategic processes and refined	Consists of a range of operational efficiency, control and quality (including customer) metrics across business processes central to delivering value to clients	• Revenue , profit, operating JAWS • Cross-sell ratio • Market share • Operational losses • % of key processes automated • % variance to agreed SLA • Staff and infrastructure utilisation • % of value adding activities within major core processes

Source: PwC

Although performance drivers are likely to be similar across banks and across product areas, the specific business, organisational and operating model and the selected customer segments being served can have a significant impact on which drivers have the most influence on business performance.

Performance drivers can be identified by understanding what drives revenues and costs at a product level. To illustrate this, Figure 2.1 sets out examples of typical product cost and revenue drivers.

Cross-sale opportunities

However, simply focusing on products will not allow the bank to identify and capitalise on the all-important cross-selling opportunities. It may also encourage teams to operate in narrow silos. Therefore, it is important to take account of the drivers of revenue and cost at a customer level. At times this requires considering indirect revenue drivers. Examples might include identifying what creates closer engagement, which has been shown to increase revenue and profitability.

The customer drivers may differ significantly according to the particular segment and can result in very different cost to serve models. This is explored in more detail in a subsequent article on understanding customer needs on pages 27 to 35. Figure 2.1 sets out examples of typical categories of customer drivers.

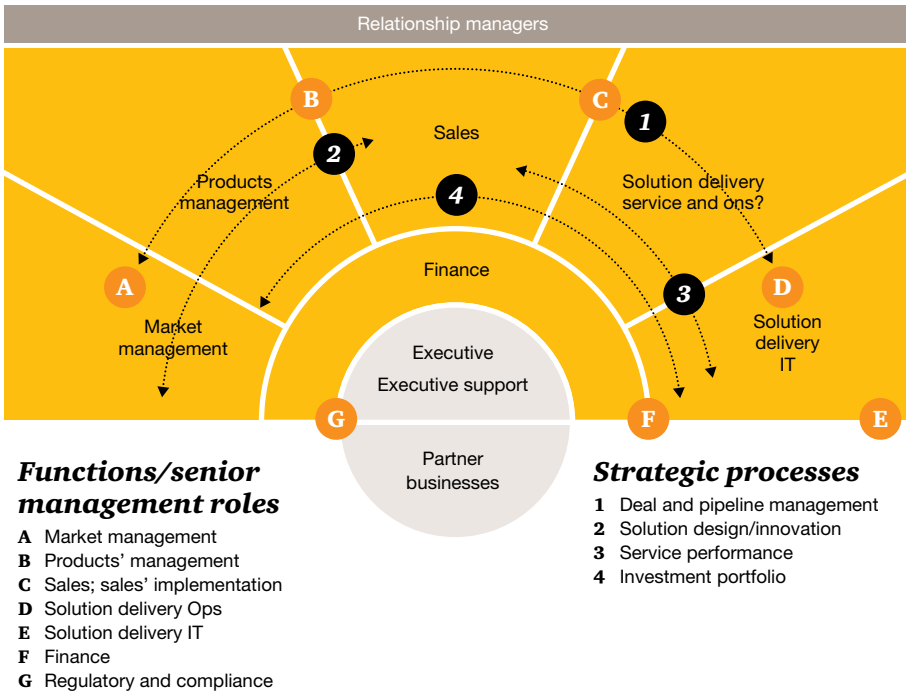
Although customer drivers can help identify what is important in driving revenue, it does not always translate neatly into key management areas of focus as it is difficult to see the end-to-end impact on the business and how to manage in existing functional structures.

Balancing value, operating performance and control

A useful way of bringing all these drivers together is to look at the organisation-wide processes needed to execute them and how these perform in tandem. Strategic processes look at the business from a customer service perspective across functional areas, highlighting how different teams need to cooperate and where handovers or duplication could limit performance. For example, the sales management and pipeline process is not exclusively the domain of relationship managers and needs the right type of support and input from a number of other functional areas including product teams. When considering different roles, another example would be how a relationship manager would need to collaborate with product management, sales and delivery of solutions (see Figure 2.2). Understanding the type of input required and setting targets around this helps to coordinate and align business performance.

Figure 2.2 Key cross-functional strategic processes for managing performance

Initial metrics will be functionally aligned but a needs-based approach will need to progress to metrics, which follow 'strategic process' – these by their nature are cross-function and frequently business



Source: PwC

It is also useful to consider the key drivers of business performance, namely operational performance (cost), value (quality) and control (including compliance and sustainable contributions). If all of these three driver categories perform well, profit will be strengthened. However, it is as much about individual performance of a driver as it is about managing the balance between the drivers which is critical to strong performance. This approach helps to identify value drivers along the course of the strategic processes that need to be managed closely by management.

Operational performance management is clearly critical to high performance, cost management and operational efficiency, and is generally already under close scrutiny. For example, many banks monitor straight-through-processing (STP) rates, utilisation of staff, etc. However, managing cost for cost's sake alone can have a detrimental impact on business performance. Operational performance therefore needs to be considered in conjunction with two other critical driver areas, namely control and value. Control drivers are critical in building a sustainable business, particularly in areas that are reliant on technology and consistency, as are many of the processing type products in transaction banking. Examples of control drivers include treasury claims and the second line of defence headcount – high numbers for either of these indicate a poor control environment.

Most importantly, value (quality) drivers ensure alignment with customer needs. This relates directly to what different segments most value; what they are most prepared to pay for and/or what will most likely encourage loyalty and engagement. These are the keys to moving from a transactional to a relationship view of transaction banking.

Seeing the wood for the trees

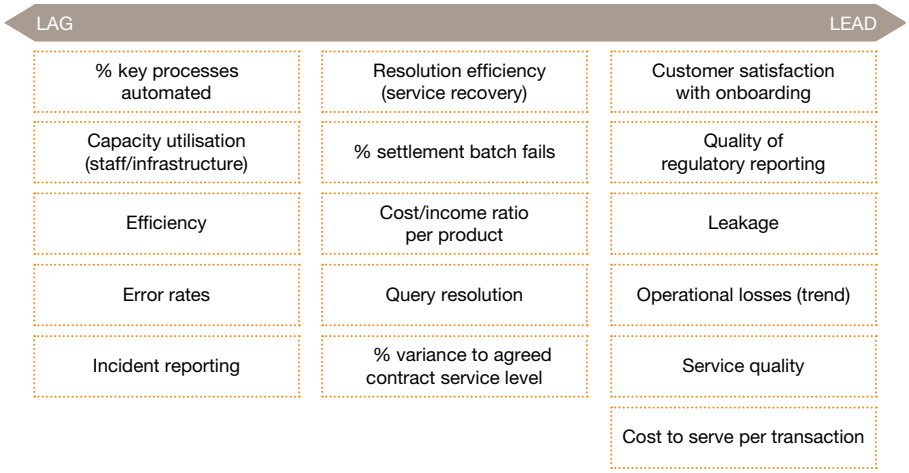
Many transaction banks have made significant strides in measuring and monitoring almost every part of their business. Whereas this level of scrutiny is laudable, it has also made it much harder for executives to know how best to manage a customer franchise across various product areas. Many banks are suffering from too much information and too little direction. They need to cut through to what really generates value. A simpler and more tangible set of objectives and measures of progress will make sure that the organisation knows precisely what to do and how far they need to go.

Therefore, if the main aim of performance measurement and monitoring is to stimulate debate and guide management action, then reporting should reflect the priorities of each level of the organisation. Executives will want a dashboard detailing performance against key strategic objectives. This will help them to determine the focus and direction for their management teams. Management will look more closely at the specific performance drivers and how to lever them in the most effective way. The strategic processes provide the forensic view needed to manage the business at all levels. They will also need lead and lag indicators as the basis for the reporting on performance drivers sent up to executives and an early warning system for any necessary board-level response. Figure 2.3 provides examples of typical lead and lag indicators.

The monitoring of performance should highlight any exceptions and what steps would be needed to bring the business back on-track. This can then be turned into an action plan, which drills down into the processes that will have to be brought up to scratch to address underperformance.

Although the metrics that correspond to each of the main performance drivers will typically include a combination of lead and lag metrics and financial and non-financial indicators, the intention is not to develop a balanced scorecard to cover all aspects of the business. Rather, it is to develop a focused balanced view of carefully identified and selected performance driver metrics, which are aligned with the overall strategy and customer franchise of the business.

Figure 2.3 Examples of metrics in operations and service across a lag-lead spectrum



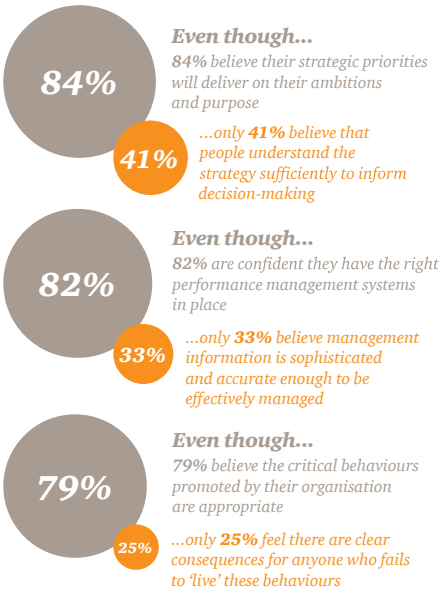
Source: PwC

Having pinpointed the key performance drivers and how to measure them, management can then set targets that need to be reached over time – this is critical to direction, focus and knowing when progress has been made. Measuring progress against targets can provide the starting point for a structured debate about what may need to shift to attain a particular objective.

Doing the right thing

Even where organisations have successfully identified key performance drivers, this does not guarantee that the performance dial will move. Poor execution is typically rooted in poor engagement with people and lack of focus on the behaviours required across a particular organisational structure. A recent survey of Australian organisations highlighted that whereas more than 80% of respondents felt their organisation had the right strategy, only 4% felt the strategy was executed properly. A number of 'blind spots' related to behaviours and staff performance were highlighted (see Figure 2.4).

Figure 2.4 Failing to bring staff on board



Source: PwC analysis, Performance Alignment Framework

Our work across a number of industries has highlighted the importance of an organisational and operational framework, capable of bringing together strategy and execution. The leadership model outlined in Figure 2.5 is a necessary condition for successful execution and explicitly addresses the transition aspect of change. It recognises that execution is ultimately about how people behave and take decisions on a daily basis – if this doesn't change, neither will performance. The key barriers to execution are behavioural in nature, but many traditional change management initiatives primarily focus on systems, processes and controls.

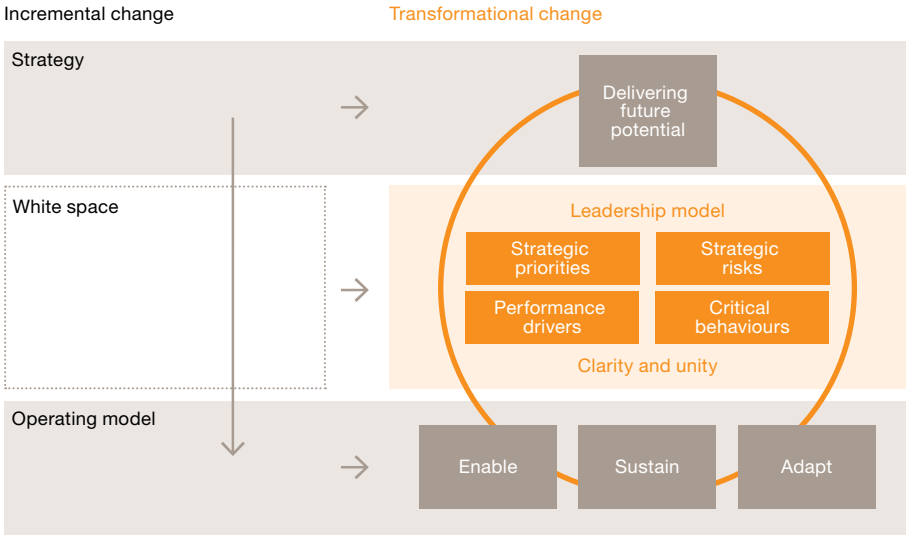
Ways to bring the desired behaviour into line with performance objectives include incentive structures, performance metrics, talent and performance management processes and recognition such as awards.

If behaviour is not aligned with the desired culture and objectives of the organisation, it is important to work out why. For example, Capitalise: Product sales are incentivised with revenue targets; they are likely to carry out their own client targeting and relationship campaigns rather than working collaboratively to develop client solutions. Behaviour is the key to balancing the business performance drivers of value, operational performance and control, and encouraging people to 'do the right thing'.

The relationship between organisational design and behaviour is especially important in transaction banking. Global banks typically manage matrix structures and the debate between product-led management and relationship/customer franchise models is ongoing. A number of large banks have recently reorganised to refocus on their customer franchise – where others have strengthened their product focus (see Figure 2.6).

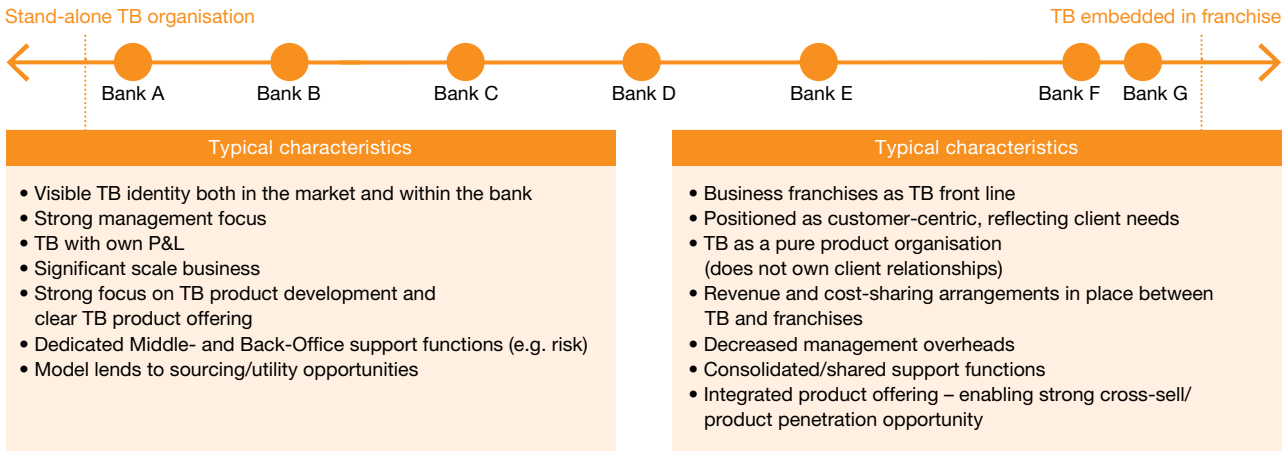
Figure 2.5 Focusing on the leadership model will drive alignment

Many organisations fail in execution because they have no model to link strategy to operating model. The leadership model is a critical execution link.



Source: PwC

Figure 2.6 Operating and organisational model options in transaction banking



Source: PwC

Regardless of the structure, matrix reporting lines, conflicting business priorities and targets, and duplication of efforts are often prevalent. Formal organisational design can be effective in positioning a bank to win and retain business. Even without formal restructuring, at a minimum, informal alignment around responsibilities, accountabilities, governance, decision making structures and how people interact and how their performance is measured will make a real difference to performance. This takes the principles of organisational design and applies them to align contributing businesses to the overall strategy for a franchise.

Coming together for the customer

A key element of organisational design is making sure that teams are pulling together in support of the client. This includes making sure that client-facing staff can spend as much time as possible getting to know the businesses they serve, identifying the issues they are coming up against and the sales opportunities this might open up for the bank. This in turn means ensuring that tasks that distract them from this focus are taken care of by others wherever possible, or at least made more efficient and less time-consuming.

It might also include identifying areas where people within the organisation might be competing against each other – and ultimately against the client. Examples include clarifying how different product areas need to work together to develop solutions for clients, rather than ad hoc selling. This would in turn mean making sure that the sales team provides a single point of client contact and service coordination.

From a cultural perspective, this collaborative approach includes a readiness to share in success between teams that may in the past have operated separately and may now be extended over considerable physical distances and/or across financial reporting lines.

Getting on top of the housekeeping

Implementing a performance management framework informed by deep insight into customer needs will require investment. However, good housekeeping around revenue will help finance this investment and one of the first things we help customers do is to address leakage of revenue and lost market share.

The first refers to situations where the bank has won the particular business, but is not able to collect the revenues due from its own franchise, i.e. leakage. The second relates to business lost to competitors – often as a result of not meeting customers most critical needs.

Revenue leakage can typically occur in four areas of transaction banking:

Onboarding: the accuracy of customer details and contract terms affecting services provided and billed

Data integrity: the accuracy of data flows across the entity and the integrity of IT systems and external reference data

Transaction processing: the completeness of transactions and their consistency with agreed terms

Fee management: the completeness and accuracy of settlement processes, payments and fees charged for services rendered.

Our research suggests that savings of 0.5–1.0% of turnover can be identified through a forensic review of strategic processes. We have been able to identify seven key revenue leakage drivers in transaction banking:

- Complex data formats containing multiple fields
- High transaction volumes and multiple currencies
- Incomplete handover of data between complex systems
- IT failures, system upgrades and change management
- Inaccurate customer data
- Multiple and diverse products, rates and fees
- Poor customer and third-party relations
- Control deficiencies and fraud.

An underlying challenge is that the units managing these strategic processes and operations may not have responsibility for revenue generation. By building metrics around completeness of revenue capture into performance objectives, behaviours and incentives may be more aligned to revenue protection.

Most banks have the opportunity to identify 0.5-1% of lost turnover through a forensic review of their operating processes. In addition, primary research can help identify how to win back market share on lost cross-sell opportunities.

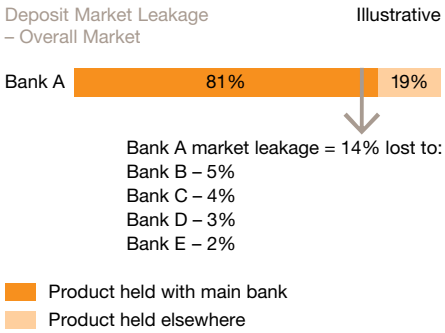
Managing for performance is about cutting through the multitude of metrics and understanding the trade-offs so that clear decisions can be made to align the organisation around drivers of value to the customer, organisation and shareholders.

Assessing customer needs

In addition to the revenue leakage review, it is possible to cut down on missed income through a clearer and more systematic assessment of customer needs. This assessment combines primary customer research and an evaluation of the addressable market size for particular products and segments.

The first priority is to understand the potential loss of wallet, over time, to competitors through an understanding of differences in market share between related customers. This can identify specific products where a bank is not competitive. We have helped banks identify market leakage of up to 16% for particular product categories.

Figure 2.7 Benchmarking where revenue may be lost



The primary research is key in helping banks to discover which competitors are gaining market share and where this lost wallet is being spent, using deposit leakage diagram to illustrate this point. Through deeper customer segmentation, e.g. by size, sector and other segmentation drivers, the bank can understand if the revenue leakage is specific to, or worse in, particular customer segments.

The second priority focuses on identifying how to improve wallet share and cross-sell through deeper insight into customer needs. Leading banks are working to develop a clearer picture of which key customer engagement drivers they are under-delivering on, compared to competitors, and thereby identify management actions to close the gap. Although switching rates between banks are typically low (2–3%), low engagement scores place a bank at particular risk of losing customers to competitors. This market insight is invaluable in setting strategy and identifying tactical actions to improve performance and cross-sell over time.

Cutting through to the value

A bank that is clear about what their customers value, how to translate this into revenue and how to get the organisation working in harmony to deliver for the client is going to be winning and retaining more business. Banks that are still feeling their way or continuing to be everything to everyone, rather than cutting through to what really matters are not just going to be missing out on the best business, but also delivering much lower returns on the business they do secure.

Managing the business for performance is ultimately about the success of management in recognising trade-offs and making clear decisions that set direction and align the organisation around areas of focus that will drive performance.

Understanding customer needs

Customer needs and the way they expect to be served are evolving rapidly across all the main transaction banking segments of corporate, small and medium-size enterprises (SMEs), and financial institutions (FI). How can banks meet these expectations in the most efficient, competitive and profitable way?

Although the broad set of transaction banking products are relevant to all three main segments, their needs and relative use vary markedly. More importantly, the products that will add most value to the client and the bank will vary from segment to segment and from customer to customer. How can banks cut through to what is most relevant and will deliver most value?

Banks also need to develop the right service model to win and hold on to business in the most profitable way. One of the main challenges is how this service model will need to adapt to changing customer expectations and acute cost-consciousness among both banks and their customers. An example of this is that while for decades the assignment of a dedicated relationship manager and quarterly site visits may have defined premium service, this may be significantly more costly than online engagement through a 'virtual agent', who can interact with the client on a much more frequent and responsive basis. Customers do not want to pay for premium services that add no real value to their business. It is important to challenge existing perceptions of what is valuable and what customers really want.

How customer needs are changing

SME

- Need to cut costs and seek out new markets
- Digital tipping point – closer to retail in what they use as consumers and ability to address cost to serve
- Digital has been shown to develop greater customer engagement, advocacy and retention

CORPORATE

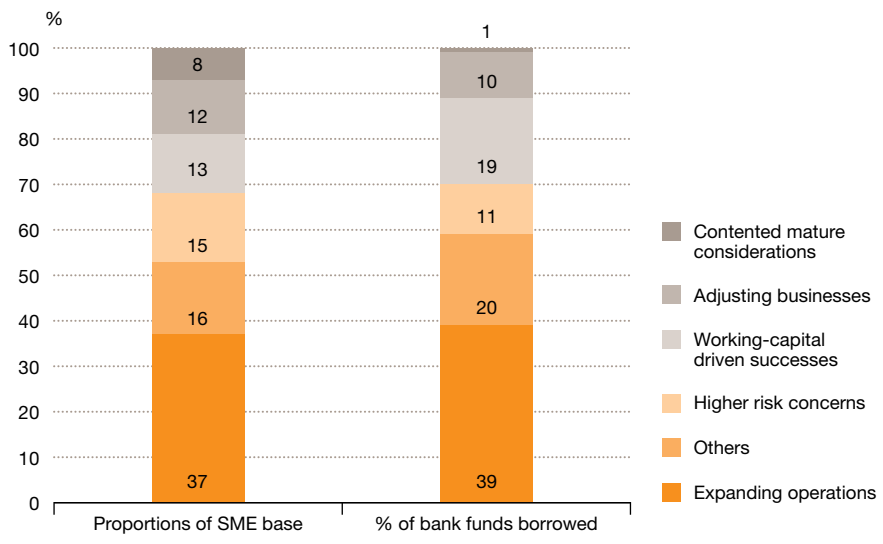
- Changing credit intermediation as customers seek out more non-bank finance
- Rebuilding relationship, not just servicing corporate treasurer, but wider corporate contacts
- Provision of solutions through the financial supply train to drive efficient working capital

FI

- Clear needs, but difficult to continue to service the whole of the market, which is being reshaped by regulation
- Emerging models, e.g. custody, client money
- Emerging segmentation and new pricing structure

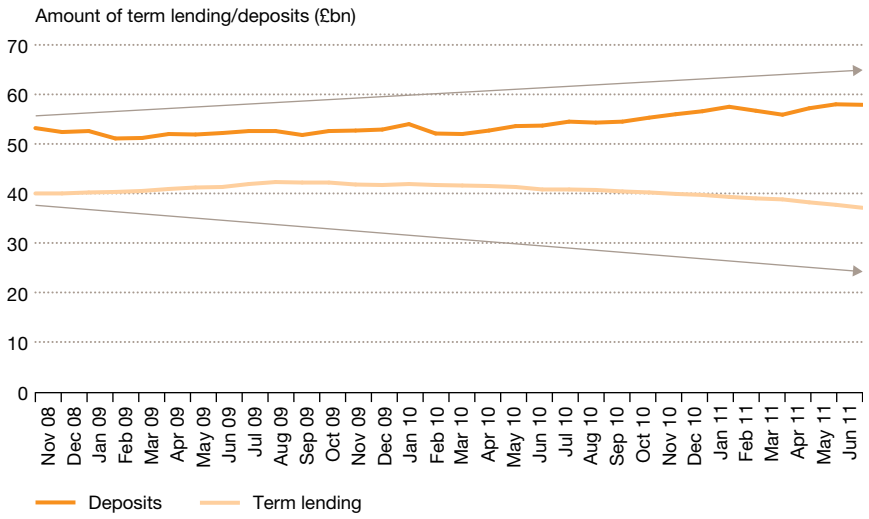
This article explores the key needs of the three main transaction banking segments, beginning with the impact of the digital tipping point on SME expectations, then moving through to how the desire to be less dependent on bank funding is reshaping corporate needs and then how regulation is creating a more fragmented, but clearly segmented, FI market.

Figure 2.8 SMEs by financial needs



Source: Experian, January 2012

Figure 2.9 The business environment has become more difficult with SMEs' changing behaviour – deposits have increased while lending volumes have fallen



Note: Small businesses refer to commercial businesses with an annual bank account debit with turnover up to £1m turnover. Contributors to this survey are Barclays, Clydesdale (including Yorkshire Bank), HSBC, Lloyds (incl HBOS), RBS (incl NatWest), Santander UK (incl Alliance & Leicester) and Co-operative Bank
Source: BBA

The digital tipping point for SME

Economic conditions have rarely, if ever, been more challenging for developed market SMEs. As pressure on demand and margins continue to mount, companies need to find further ways to cut costs. As discretionary spending falls away and once profitable businesses struggle, management need to find ways to turn them around. The parallel priority is seeking out new sources of growth, be this opportunities for innovation or reaching into regions they may not have considered prior to the financial crisis.[2] These changing SME demands present both a challenge and an opportunity for transaction banks. Figure 2.8 (on page 27), highlights the varying needs of SME companies, all of which are likely to require different kinds of support from their banks.

For banks, the pressing need to find ways to respond to these demands and develop the resulting fee income opportunities is heightened by the continuing fall in lending volumes (see Figure 2.9). The underlying challenge is how to meet many governments' demands to boost affordable lending to SMEs while controlling the cost, risk and capital impact.

Traditionally, banks have tried to understand SME needs by sector. Although this is a valid approach to understanding similarities in the use of transaction banking products, it is not helpful in understanding what a particular SME most needs at a point in time. A business focused on developing a presence in fast-growing emerging markets, calling for high levels of finance and international transaction support will have vastly different needs for bank services and advice to a business struggling to manage working capital in the face of pressures on costs and reduced customer demand in recessionary local markets, as Figure 2.8 illustrates. Leading banks are exploring innovative ways to segment their customers and understand their real financial needs including considering growth, international presence, risk profile and working capital position.

The main source of value for clients and income for banks as Figure 2.9 illustrates in this new market will no longer be traditional finance and interest revenue, but targeted business support and appropriate forms of financing.

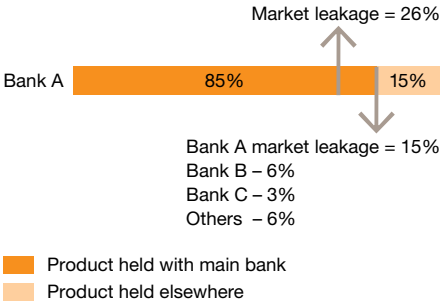
This shift in focus will in turn demand new ways of defining value, organising the business and managing performance, along with the culture within the bank that underpins this – few have yet to make the leap.

Development of digital services and engagement can address a number of the challenges – from providing advisory-led solutions and innovative financing, to a cost-effective way to interact with customers and build customer primacy.

SME business managers and owners are typically closer to the retail market in terms of customer experience and increasingly want the same ease, accessibility and intuition as they have become accustomed to when buying personal goods over the internet.

Figure 2.10 FX Protection revenue leakage

FX protection is a product that banks should on-sell with the FX business – however, an analysis of the market shows that significant revenue potential for Bank A is being leaked to competitors.



Source: PwC

2. The direction of business development was highlighted in a PwC survey of mid-market companies ('Realising ambitions for growth' 2011), which found that international business will account for 55% of their sales by 2016, compared to 47% today.

Similarly, SMEs are looking to banks to help analyse their transaction history and provide them with key financial insights and guidance.

Competition is also mounting as new entrants move into the SME market and related areas of the value chain such as electronic payments, non-bank lending and transactional FX (see Figure 2.10) – in the UK, the market shares of the four leading banking groups have fallen as a result.[3] Many of the newcomers are looking to target particular niches or develop innovative ways to attract and engage with customers. While most banks have sought to cut costs and reduce lending autonomy within their SME operations, it is notable that some entrants are moving back to a traditional relationship -focused strategy, in which decisions are devolved to local teams. Other banks are increasingly looking to digital to offer cost effective ways to serve customers. Regardless of the approach chosen, the key to success in this segment is to find innovative and cost-effective ways to develop customer intimacy and better understand the needs of customers.

Technology offers structured and cost-effective ways to interact more closely with customers and help banks to anticipate their needs. Innovative examples include iPad apps which provide up-to-date information on cash flows, backed up by alerts and guidance to help companies manage their finances more effectively. The key benefit for banks is in cementing engagement, providing cues to start conversations with clients and predictive leads for sales opportunities.

The new frontier of customer insight will be how to aggregate and extract profiling data from all the purchasing, payment, social media and other digital trails businesses leave. Banks can use these insights to serve their customers better and play back the results to them to support management and business development.

So in conclusion, SME market service and operating models within many banks are no longer equipped to deal with evolving market realities. New approaches to SME segmentation and customer profiling would allow institutions to anticipate customer needs and move in quickly on opportunities without the high fixed costs of traditional relationship banking.

Corporate credit intermediation and new buyer models

In future, credit-brokering will no longer be the main source of banking revenue. For larger corporates, banks have ceased to be the cheapest or even the preferred source of funding and many businesses are looking to accumulate more cash and reduce reliance on their banks. This is causing banks to develop new relationship models with corporate customers centred on serving a full range of corporate needs and engaging across multiple buying points.

Last year, we reported on how difficulties in accessing bank funding at the height of the initial credit crunch had made sustaining liquidity the top priority for corporate customers.[4] As a result, they have been seeking to become less bank-dependent. Access to the bond market has increased (financial bank independence) and solutions like payment factories and in-house banks have been back at the top of treasurers' agendas (operational bank independence). A key priority is how to extract and concentrate cash more quickly and effectively via bank liquidity solutions or internal working capital initiatives. The flip side has been judging where to deposit extra funds in the face of growing concerns over counterparty risk, with many corporates choosing to spread their cash around a number of banks, so slackening relationships still further. Corporates have tended to make more use of multiple providers and are more comfortable switching banks for a range of product needs as a result of the loss of primacy of the funding relationship.

Working capital is replacing credit as the key driver of customer stickiness, but also requires banks to understand their customer needs more deeply and to expand their customer relationships beyond that with the corporate treasurer.

3. PwC analysis.
4. The move away from bank finance as the preferred option was highlighted in the PwC Global Treasury Survey 2010.

The challenge for banks is to find new ways to develop enduring relationships ('stickiness') and increase wallet-share in this new era of 'independence from banks'. The stark fact is that credit is no longer going to be the mainstay of banks' business and they will have to develop new fee-income opportunities to make up for this and sustain their commercial relevance. This in turn demands a different form of relationship with customers, built around insight, empathy and a fresh set of products and solutions that draw on greater engagement and understanding. A broader understanding of corporate priorities beyond pure financing will highlight emerging relationship touch points.

The traditional corporate treasurer cycle (see Figure 2.11) cemented the bank relationship around the funding needs. The supporting corporate treasury cycle provided a view of total customer needs and a customer view of bank products. However, banks need to find a new way to make the client sticky. We believe stickiness in future will be largely dependent on the right service and solution model (assuming that products are broadly undifferentiated).

Figure 2.11 Expanding contacts: The new relationship map

The new corporate banking environment demands banks to understand a much broader map of relationships and roles.

Source: PwC

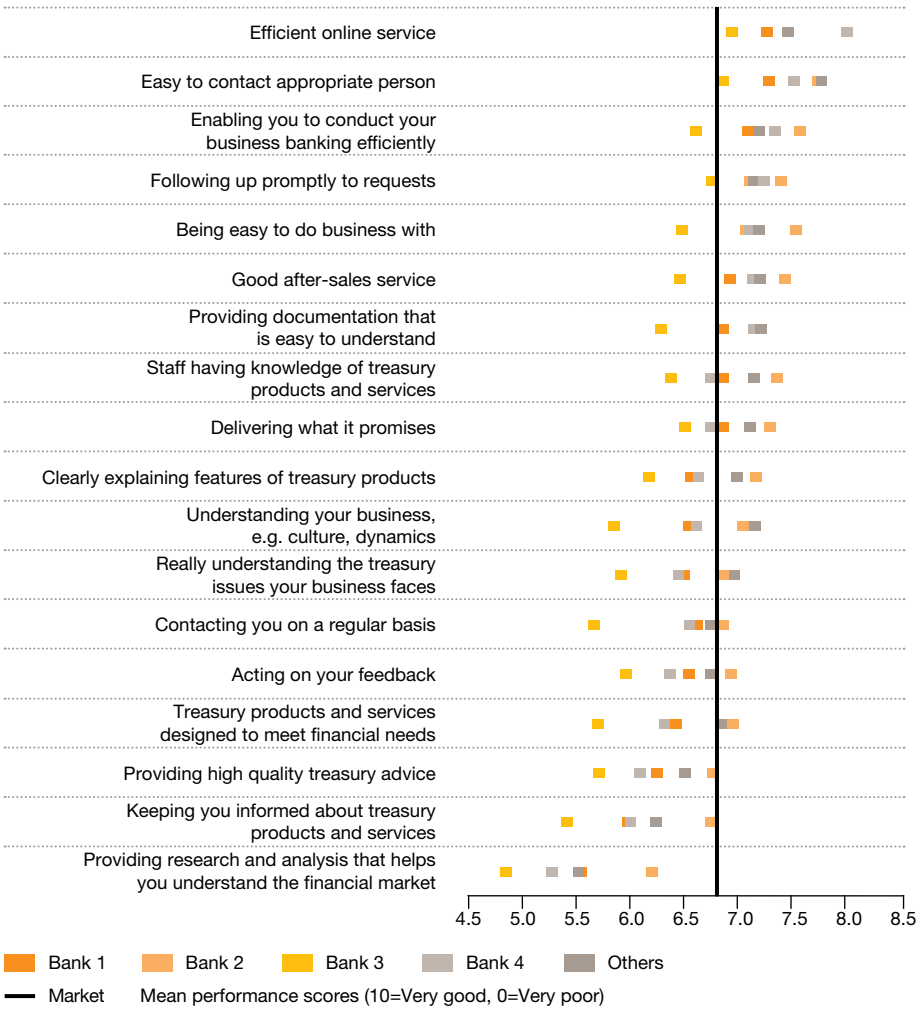
We believe that working capital will increasingly replace core funding as the entry point of the buying cycle. Working capital offers more opportunities for solution selling and cross-selling of 'adjacent' products, but simultaneously demands a much better understanding of a broad base of customer processes and requirements. This has expanded the buyer group beyond corporate treasury – other departments are now playing a stronger role in the buying process and it will be important for banks to reach out to them. This includes procurement, which is playing a stronger role in the decision-making process, particularly in areas such as supply chain finance (reverse factoring) programmes, commodity hedging and guarantees, letters of credit and trade finance operations. Other key buying groups may include shared service centres for working capital solutions, property managers for sales and lease-back operations, and facility managers for leasing and car schemes.

Although this creates an additional layer of complexity for banks, it also highlights an emerging area of innovation. Through a better understanding of the various buying points, better data on these areas and the unmet customer needs, banks have valuable information that they can use to develop adjacent or supporting products. Typically, these products (ranging from solicitor services to document administration to working capital forecasting) do not rely on favourable interest rates and offer value-added fee-based pricing opportunities.

The most successful banks are moving from a transactional to a multi-targeted relationship focus. They are also taking the time to understand and anticipate corporate customers' changing requirements, as well as their strategic agendas and priorities, and develop new points of stickiness and long-term customer relationships that do not depend on the availability of credit.

Understanding the drivers of engagement are critical to growing revenue in the customer space.

Figure 2.12 Market performance across a range of engagement drivers in the corporate banking sector



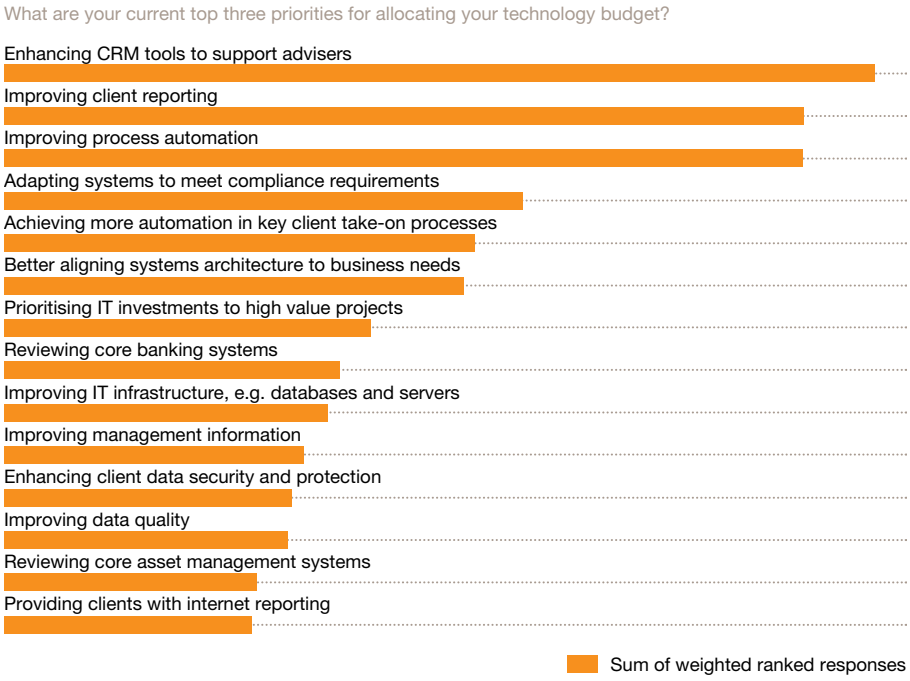
Source: PwC

As Figure 2.12 highlights, the UK banking industry scores increasingly poorly in areas that require greater intimacy and understanding of the client. Addressing this engagement gap in a cost efficient way will be central to successful client driven models.

The key performance realities in the corporate market are therefore to understand what will replace credit to develop sticky business and customer primacy, to understand and engage with multiple buyers and to address the engagement drivers of this enlarged buyer space to attract, retain and grow business.

The FI sector is experiencing significant regulatory change and as a result banks need to be more selective and focused about the choices they offer customer and therefore the customer segments they choose to serve. Customers will increasingly need to make trade-offs between reducing cost and mitigating risk as new pricing models emerge.

Figure 2.13 Asset managers' priorities



Source: Growth in a cold climate: key findings from the Asset Management Sector, PwC, 2012

Competing in a reshaped FI market

A reshaped FI transaction banking market is set to emerge as a result of regulatory change and the pressure to cut costs, creating huge new challenges for banks serving financial institutions.

Increased competition and downward pressure on management fees are key cost drivers. According to the PwC CEO Survey of Asset Managers (2012), 66% of CEOs plan to continue cutting costs. Cost reduction through enhanced efficiency is a top budgetary priority (see Figure 2.13). Operations and technology typically represent 40–50% of asset managers' costs,[5] and directly relate to key areas of regulatory change and the likely intersection of bank services to asset managers. In particular, the need for greater transparency and comparability will require improved client reporting and customer relation-ship management (CRM) tools, supported by process automation and meeting a wider set of compliance requirements.

At the same time, the mounting demands on asset management companies open up opportunities for transaction banks to provide greater levels of operational support – 40% of CEOs are still focused on outsourcing business processes.[6] With such a wide range of different types of FI customers just within the investor market, the biggest challenge facing banks is how best to service customers, given the vast differences in scale and complexity. The ability and desire to pay for services will differ, based on factors such as size of the customer, volume of transactions (and therefore ability to benefit from economies of scale), in-house sophistication and capabilities.

The changes in the over-the-counter (OTC) derivatives market in the wake of the US Dodd-Frank Act and the European Market Infrastructure Regulation (EMIR) illustrate the emerging complexity of servicing a range of different customer needs and scale of customer business. With the drive towards central clearing for OTC derivative trades, buy-side OTC market participants will be seeking to obtain clearing services from relatively few clearing brokers – demand for clearing services is therefore likely to exceed supply.

Central clearing is also likely to spur greater product standardisation and pressure on trading margins for some products. Providing clearing services for standardised derivative products is expected to be a low margin business and, given the level of investment required, revenues from clearing are not seen as being the justification for entering this market. Providing clearing to go with execution is seen as a defensive play to avoid having to give up client trades to a competitor to clear. Furthermore, there are opportunities to generate revenues from supplementary services such as collateral transformations and the provision of liquidity to cover margin calls, for example.

5. Growth in a cold climate: key findings from the Asset Management Sector, PwC, 2012.
6. Growth in a cold climate: key findings from the Asset Management Sector, PwC, 2012.

The larger and more sophisticated clients will provide the volume and diversity of business activity needed to justify providing clearing services. However, clients with more modest needs will be less profitable and hence less attractive. For such organisations, clearing costs are likely to present a challenge, whether that is from the fees or gaining access to other services at cost-effective rates. The challenge is finding a commercial rationale for investing in a business where market uncertainty and regulatory pressure make it hard to foresee an acceptable return on investment. Strategic choices around client franchise, product suite, competitive actions, and availability of high quality collateral and strategic partnerships will be key to understanding how best to compete in this reshaped market. Figure 2.14 sets out some of the key strategic considerations.

Figure 2.14 Strategic considerations in a changing FI market

Client franchise	Is there clarity on the expected performance of targeted client segments given available capabilities and competition? How is profitability impacted by the changing cost structure?
Product suite	Clearing services tend to be sticky. Lost clearing business potentially places other revenue streams (execution, investment banking, etc.) at risk too – do business plans take this into account?
Competitive actions	To what extent will competition for clearing and collateral revenues increase in a particular client segment? How does this impact revenues in related businesses serving the same client franchise?
High quality collateral	Can the requirement for high quality collateral translate into a new revenue opportunity – for example, through the provision of collateral transformation services?
Strategic partnerships	A partnership or JV can provide access to much needed technology, infrastructure, or high quality collateral. How will potential JV partners be sourced and evaluated?

Source: PwC

Another example of how regulatory change is deepening the segmentation of FI clients is the tightening of regulations on the holding of client money. The key aim is to make it easier to return funds to clients should the bank or broker fail, i.e. to better manage risks. A fundamental requirement is that firms must keep client money separate from their funds in segregated client accounts with trust status. This ensures that client money is ring-fenced, to the extent possible, in the event of insolvency. While the principle is simple, the application of the detailed rules can be complex. Grey areas that have been highlighted by recent legal challenges include when does the statutory client money trust arise, do the primary pooling arrangements apply to client money in house accounts and is participation in the pool dependent on actual segregation?

Recent changes to UK Financial Services Authority (FSA) rules (to more closely align with Dodd-Frank and EMIR) have introduced new options for multi-pooling, which effectively allows clients the discretion to choose their preferred level of segregation. Pools could be created along business lines, by client type, by individual client (under EMIR, rehypothecation is prohibited under individual segregation and individual segregation is therefore the most expensive 'pooling' choice). This will have a significant operational impact on a custodian bank, if implemented as each pool needs to be operationally and legally separate (e.g. separate bank accounts and reconciliation). To be allowed to operate multiple pools, custodians will need to separate client money reconciliations per pool, prepare a 'sub-pool terms' document, operate separate bank/transaction accounts per sub-pool, notify the regulator when creating sub-pools and give clients a disclosure document. If a firm fails, the money in each sub-pool forms a separate pot for distribution to its own beneficiaries only. Systems, controls and reporting requirements are likely to increase as clients may choose to be pooled together with trades with similar risk profiles. However, it will allow more business and cost efficiency compared to individual segregation. The challenge for banks is to determine whether there is a demand for segregated funds and at what level of segregation; what the extent of this demand is, and therefore what options they choose to offer clients.

To adequately inform the options analysis, custodians will need to consider trade-offs that customers may make between greater comfort, segregation and control versus cost-efficient clearing and custody services that may bring greater risks in the event of default. This will have implications on the operational, cost and fee structure of the custodian banks. Following the Lehman and MF Global insolvencies, making sure that assets are adequately segregated is a key client question for their service providers. We are seeing a range of models developed in the market with most evolving around three models:

1. Segregated omnibus account at custodians model (which includes rehypothecation limits on the assets that can be used by the broker)
2. Individually segregated accounts under tri-party custodian model with instructions on the excess assets not available for re-hypothecation
3. Insolvency-remote model, which is regulated by independently capitalised vehicle that holds segregated client assets.

Providing the asset management community with these choices requires flexibility in the operational model with implications for the banks' systems, client asset tracking and reporting. For both the custody and the related client money business, the changes in market structure and business model are resulting in changing pricing structures. We can expect differentiated pricing for different levels of customer service (i.e. to cover different supporting cost structures). However, pricing decisions will also need to become more strategic to attract the desired customer segment and to compete effectively. We foresee significant change in pricing in the overall FI market over the next few years – changes demanding informed insight into the needs of emerging FI segments.

Delving deeper into customer needs

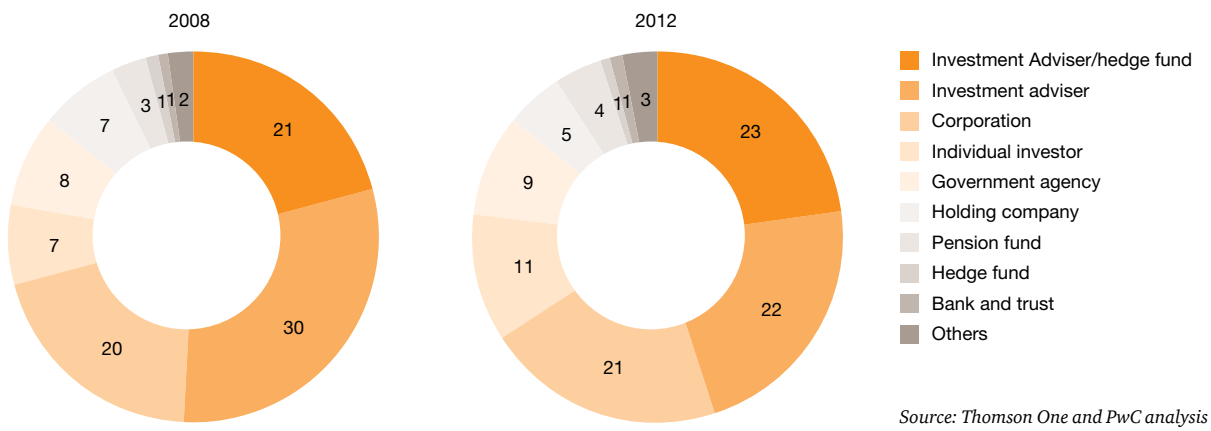
Our focus on the three key segments highlights some of the differences at a high level. However, within each of these segments further differences will exist – more targeted segmentation is the key to generating value from a customer franchise, and more importantly, developing the strength of the bank's relationships with its chosen customers.

How the investor market is being reshaped

The composition of the market is becoming ever broader and more complex (see Figure 2.15).

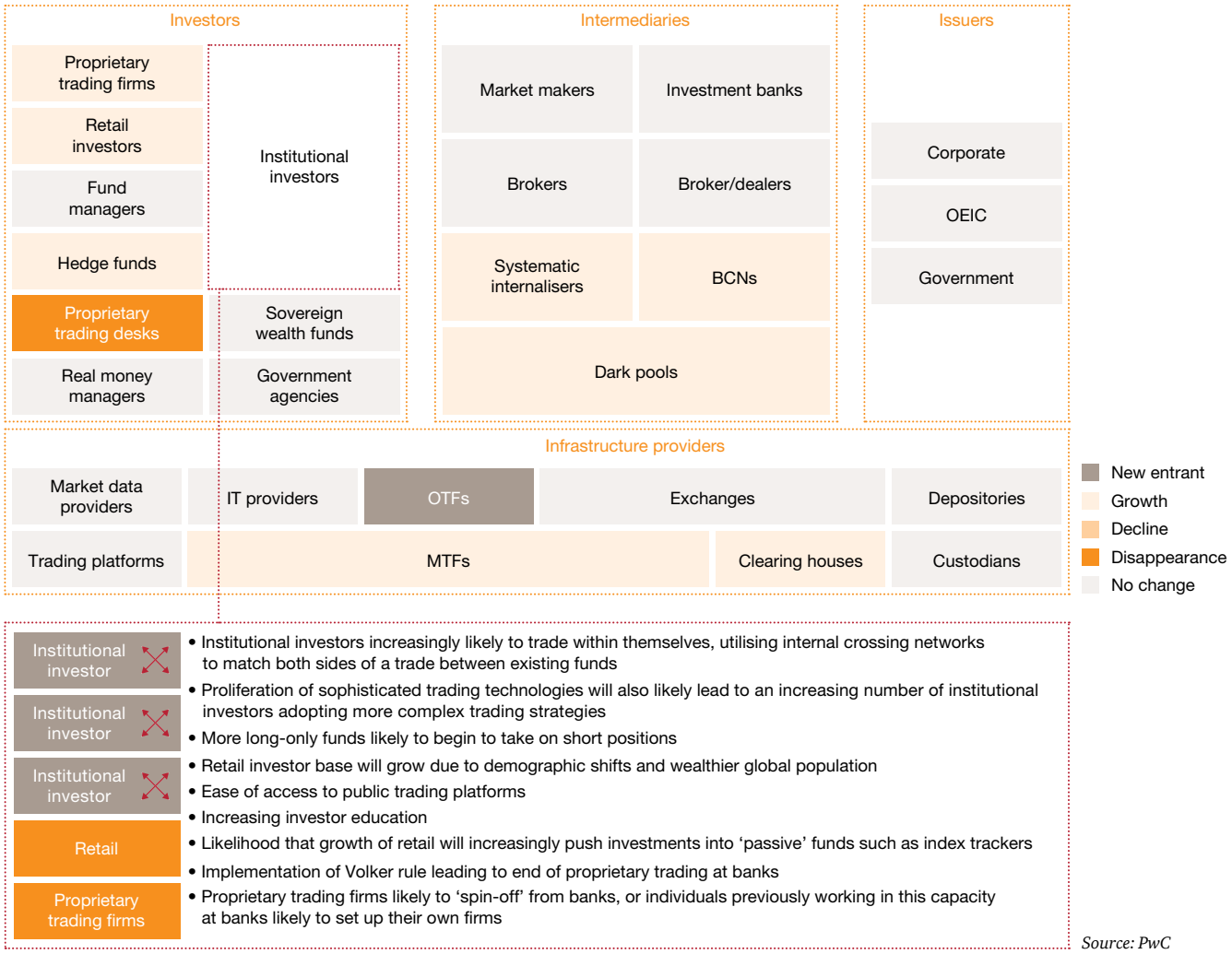
The market is also marked by innovation in new asset classes and the growth of proprietary trading firms. Figure 2.16 outlines how this is likely to affect the composition of the market.

Figure 2.15 European equity market investor composition (2008/2012)



Source: Thomson One and PwC analysis

Figure 2.16 Future market composition



Source: PwC

Section 3: Innovation and growth opportunities

Article	*Brief synopsis*
Turning innovation into a real engine for growth	The problem for many banks is not that they lack new ideas. Rather, it is how to make sure innovation is sufficiently geared to what customers value and are prepared to pay a premium for. Making sure that innovation starts and ends with the customer would help to ensure that the new ideas generate a real return.
Taking the working capital opportunity to the next level	Banks can play an important advisory role in helping their customers implement effective working capital management (WCM) to drive competitive advantage. Tailored WCM solutions, based on quality customer data and insights, can help banks forge closer relationships with clients and increase market share. Further examples include creating a supply chain network that provides more informed and collaborative ways to forecast demand, open up markets and develop new products.
Emerging partnerships in regional banking	We have seen banks developing new regional partnership options to serve their clients more effectively as increasing numbers of corporates require more comprehensive on-the-ground support in the new markets they are entering.
Entering new markets – new opportunities for servicing existing clients	This article focuses on opportunities in Asia for banks, considering the changing treasury needs in China and the growth strategies of Japanese corporates.

Turning innovation into a real engine for growth

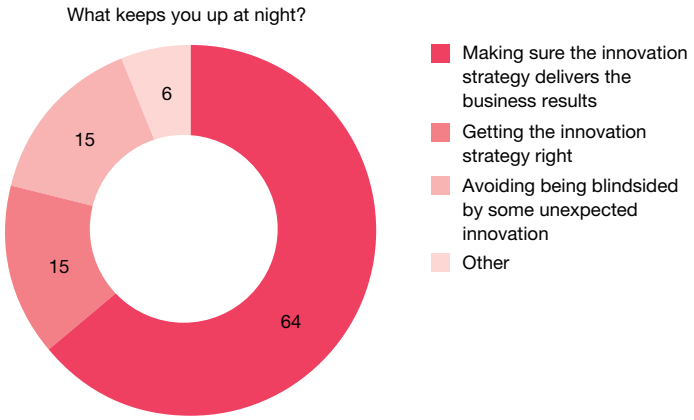
The problem for many banks is not that they lack new ideas. Rather, it is that they fail to run these ideas into commercial advantage on a repeatable basis. Transaction banking – a technology-enabled business – should be emulating its counterparts in the technology and services industries. Why then are the realities, poles apart?

In 2011, we surveyed executives from a diverse set of industries about how they approach innovation and what are the keys to turning it into increased revenue and growth. The findings act as a good template for transaction banks to learn from.

Most of the participants said that the tough economic conditions and barriers to securing growth made innovation more important than ever. The main challenge for innovation was not lack of ideas, but defining the right innovation strategy, designing the operational model and execution capabilities to support it (see Figure 3.1). In this respect, many executives felt their organisation lacked the necessary experience of driving growth via innovation. Others felt that innovation today is more complex because of the requirements to develop new business models to deal with the challenges of the current economic climate. In addressing these challenges, all the most successful innovators highlighted the importance of making sure that innovation is fully aligned with the overall business strategy.

Given the high level of customer touch points, data rich and annuity traits of transaction banking products and services, there is significant opportunity to build innovation as a repeatable, commercial and competitive asset that creates strong returns for shareholders, executives and customers alike.

Figure 3.1 Barriers to innovation



Source: 'Trends in Managing Innovation', a survey of 65 executives carried out by PwC PRTM Management Consultants in 2011.

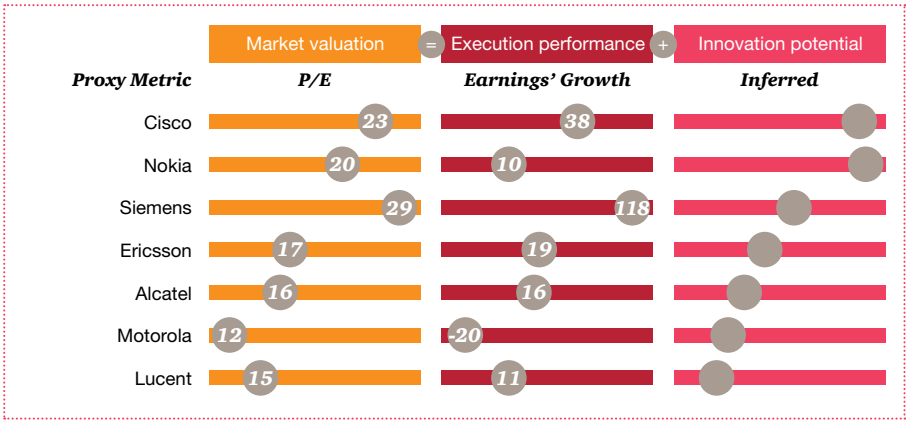
New realities

In the lead-up to the financial crisis, there was a school of thought within the transaction banking community, that by demonstrating processing efficiency externally, banks might attract superior multiples from external analysts. Since 2008, we have observed a noticeable trend for large technology corporates such as Cisco to be rated, based on their inferred innovation capabilities (see Figure 3.2). Those companies that achieve superior results and ratings do not necessarily spend the most on innovation and do not focus on the technology platforms, but customer need. Companies that take a customer-focused approach to innovation outperform their technology-based innovator cousins by 3 to 1. In our opinion, this outlines the challenge and opportunity for the transaction banks.

So what do the best needs-based innovators do? First, they have defined an explicit innovation strategy. This strategy goes beyond just products, to encompass the operating model, service, sales and distribution (including channels). The strategy aligns clearly to the corporate strategy and defines:

- **How much innovation is needed** – how much innovation should be delivered, and when, in order to support the firm's business objectives.
- **Where innovation efforts are focused** – the focus areas and relative investments in innovation types – incremental, breakthrough and radical.
- **What type of innovation is needed** – boundaries are communicated to the organisation to keep efforts focused on valuable leverage points.

Figure 3.2 Why does Wall Street value Cisco so highly?



Source: Public data, PRTM analysis

The innovation strategy is generally governed by executive management teams, with an accountable executive reporting directly to the CEO. Innovation should be viewed as delivering as much commercial benefit as the traditional revenue generating centres of sales, service, or product.

Effective execution

The best innovation companies are keenly aware that execution is the number one challenge for innovation. Common traits include a redefinition of the organisation model to flatten hierarchies and improve cross-functional collaboration. They realise that innovation is an asset that requires investment and ongoing management to deliver returns.

A number of practices are relevant for transaction banks to learn from:

- Innovating customer-centric business models – business model innovations focus on what value is delivered, how it is delivered, and who the target audience is (see Figure 3.3).
- Portfolio management – creating the right mix of day-to-day incremental innovation with breakthrough innovation while managing risk.
- Innovating with the outside – on average, Fortune 500 companies have 60 strategic alliances with external firms that they innovate with.[12] These companies may include suppliers, customers, or competitors. Top innovators also look to build their capabilities through acquisition or alliances.
- 'Middle Out' innovation – while an innovation strategy will create a top- down approach to innovation, real value can only be generated with the entire organisation focused on innovation as performance priority. Therefore, bottom-up innovation from employees and the front line is vital. In order to realise this, employees must be engaged with the innovation strategy and investment in middle management capabilities is paramount as they act as conduits for execution success.
- Talent development – many innovators are actively developing individuals who retain deep technical expertise, but also have the ability and motivation to collaborate across disciplines. Innovation also acts as a good cycle of experience for talent development.

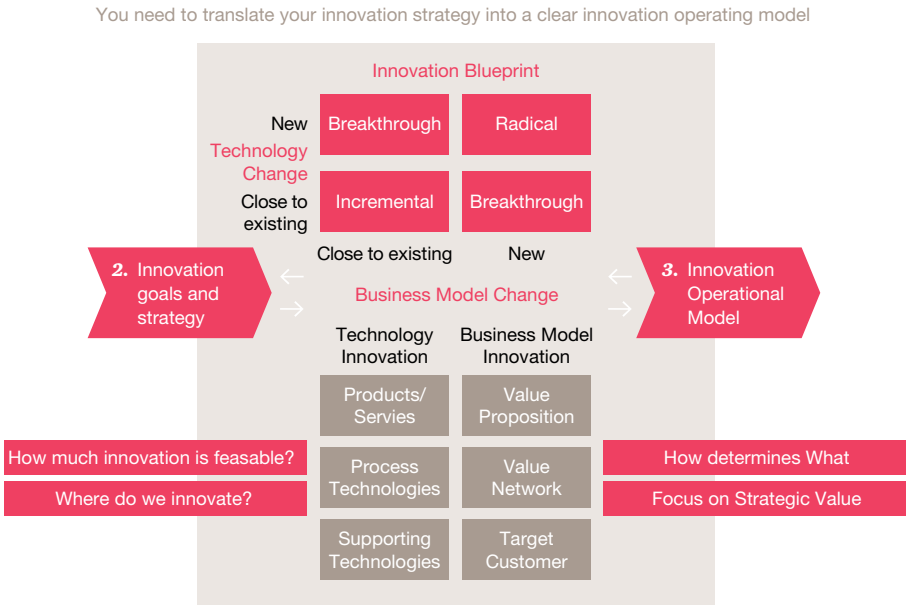
12. Source: PwC analysis.

Many ways to manage innovation

There are four approaches to managing innovation that stand out – using metrics that communicate performance against goals, leveraging a culture of innovation, incorporating process discipline and executives taking an active role in innovation teams. While metrics are the preferred method of management as they provide a clear indication of goals and progress, by themselves they are not enough.

Depending on the types of innovation chosen, all four approaches need to be brought to bear. Incremental innovation, for instance, will not require executive involvement and can be driven by simple metrics, focused on speed. Breakthrough innovations require more senior management involvement, metrics focused on value creation and motivators that encourage risk-taking.

Figure 3.3 You need to change your innovation strategy into a clear innovation operating model



Source: PwC

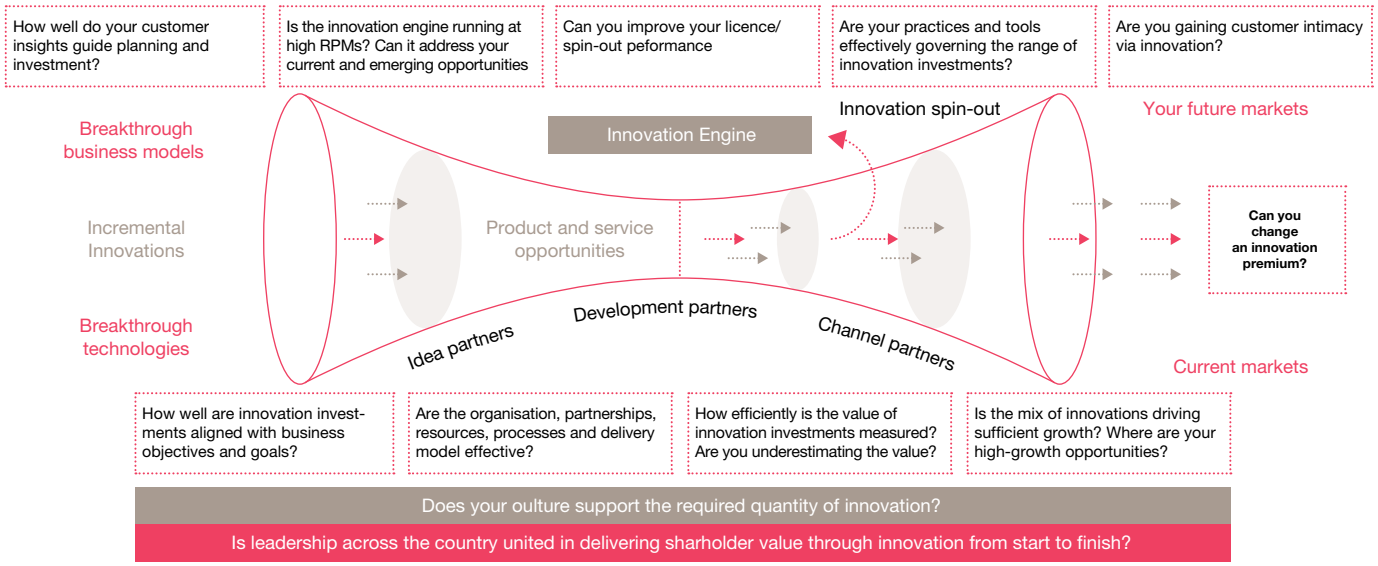
Growth potential

By redefining innovation as a commercial growth driver, transaction banks can move beyond the weak returns and tactical benefits that many firms suffer from. As Figure 3.4 highlights, this will require a number of fundamental questions to be addressed in order to align the innovation operating model to the corporate growth objectives of the bank.

Bringing new ideas to market

Opportunities for innovation in transaction banking are opening up. As we explore in the remaining articles in this section, this includes developing new solutions and sources of revenue within working capital and supply chain management. As clients reach into new markets, new partnership models are also emerging.

Figure 3.4 How to create an 'Innovation engine for growth'?



Source: PwC

Taking the working capital opportunity to the next level

Effective working capital management (WCM) is already a huge competitive differentiator for corporations as they look to reduce funding costs and free up cash for growth. For banks, the key differentiator is going to be looking beyond payments, payroll and other singular processes at how to develop comprehensive WCM solutions for their clients. We also explore developments in supply chain – a good example of where working capital performance can be addressed, but also where banks can use transactional information to better serve customers.

Working capital is the cheapest form of finance. Efficient WCM allows companies to release cash and finance their own growth without the need for additional funding.

Opportunity to deliver €400bn in value for corporates

The value of effective WCM and the growing gulf between top and bottom performers were highlighted in our analysis of the working capital performance of 4,000 of Europe's largest companies, which was carried out between 2007 and 2011. Leading performers (top 25%) were able to reduce their working capital by an average of more than €100 million, despite generating average sales growth of 40%. In contrast, the least efficient performers (bottom 25%) increased their working capital by more than €200 million.

This €300 million gap between the top and bottom performers is going to give the leaders a significant edge as they look to cut funding costs, sustain liquidity and build for the future. If all European companies in the least efficient category could achieve the same level of performance as the leaders, they could generate an extra €400 billion in cash, the equivalent of some 30% of sales. The table in Figure 3.5 provides a breakdown of the improvement opportunity.

Figure 3.5 Working capital performance comparison between 'least' and 'most' efficient performers

	Looking back 2007–2011			Looking forward	
	Good performers	Bad performers	gap good vs. bad	What could the 'bad performers' generate if they would move to 'good performers' level?	
	Average working capital change (£m)	Average working capital change (£m)	Difference between 'good' and 'bad' (£m)	Total (£m)	Average per company (£m)
BeNeLux	(61)	312	373	25,443	748
Central Europe[1]	34	81	47	2,682	117
France	121	545	424	59,752	1,245
German, Switzerland, Austria	(4)	457	461	105,855	1,163
Italy	(335)	251	586	10,023	436
Nordics	71	333	262	28,062	520
Other Southern Europe[2]	(46)	103	149	9,265	201
Russia, Ukraine	(1)	327	328	21,472	438
Spain, Portugal	(124)	489	613	12,594	630
UK, Ireland	(140)	56	196	125,282	248
Total (Europe)	**(91)**	**226**	**317**	**400,429**	**615**

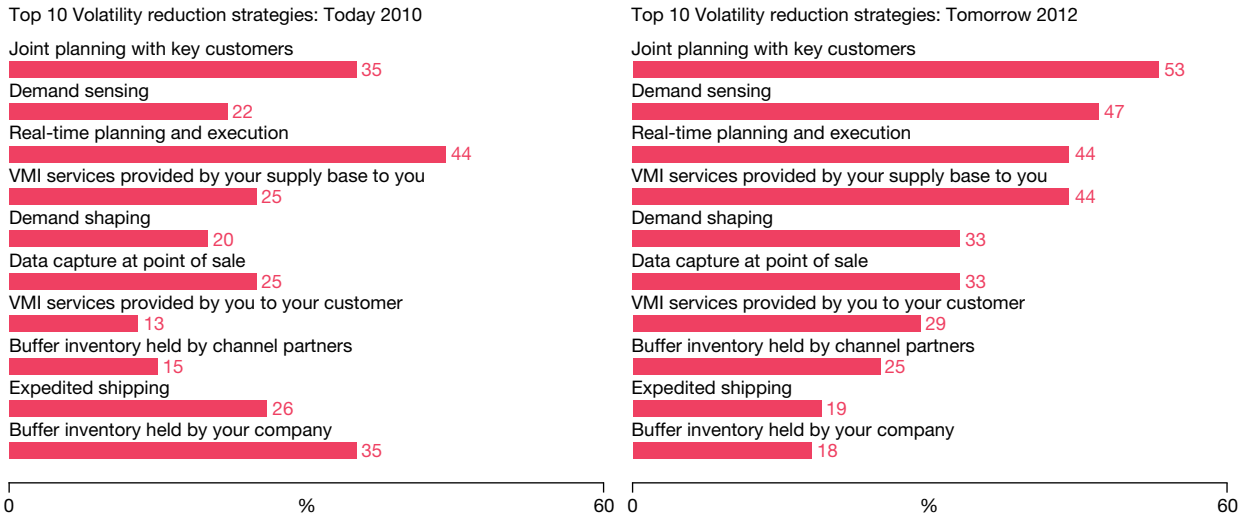
[1] Czech Republic, Estonia, Hungary, Latvia, Lithuania, Poland, Slovakia
[2] Bosnia and Herzegovina, Bulgaria, Croatia, Cyprus, Greece, Macedonia, Montenegro, Slovenia, Turkey

Source: PwC analysis, Cash for Growth, PwC Working Capital Advisory, June 2012.

So what marks out the front runners? Although there is no silver bullet to achieve good working capital performance, there are four key levers for success:

- **Commercial terms** – High performing companies understand all terms in place, and match these terms with the size and nature of the contract. Often, there are established 'preferred term' agreements in place, which are based on specifically developed models and internal and external best practices.
- **Process optimisation** – Leading players understand each individual working capital process, and have tested and evaluated these through challenging the individual process steps with balancing the trade-off between cash, cost and service.
- **Compliance and monitoring** – The most successful companies are measuring compliance to terms, processes, policies and procedures (e.g. payment terms compliance is monitored through data analysis, with consequent root cause analysis to understand the key drivers for noncompliance).
  As a result, the required changes to ensure compliance are analysed and valued by their potential cash impact. Working capital is monitored in detail via a key set of relevant operational and management KPIs.
- **Cash culture and management** – Cash is at the heart of high performing businesses, with top management sponsorship, clear accountability and responsibility for working capital performance and management. Cash also forms an important part of performance measurement and incentives.

Figure 3.6 Key trends in supply chain management



The 2010 results pointed to an increased focus on collaborative approaches to cope with volatility – the 2011 study was intended to explore the progress companies were making in these areas.

Source: PwC analysis, Cash for Growth, PwC Working Capital Advisory, June 2012

The bank opportunity

With up to €400 billion cash flow available, WCM is a huge opportunity for banks to forge closer relationships with clients and enhance wallet share. Key areas of market development have included payments and collections' factories to help clients concentrate cash and extract it for reuse more quickly.

While some of these areas are becoming increasingly commoditised, banks have an opportunity to build on the data and insights described in earlier articles to develop more comprehensive and enduring working capital solutions for their clients. This includes using peer group analysis to provide benchmark comparisons of the client's performance in key areas such as cash velocity, gearing ratio, bad debts, cost of finance and days outstanding. Presenting this analysis would allow the bank to open up a strategic conversation. They could then develop targeted and tailored solutions built around any shortfalls in these metrics and then track performance as part of its continued support and relationship.

Supply chain potential

Supply chain is a good example of where banks can help improve working capital and use the analytical insight to build stronger relationships.

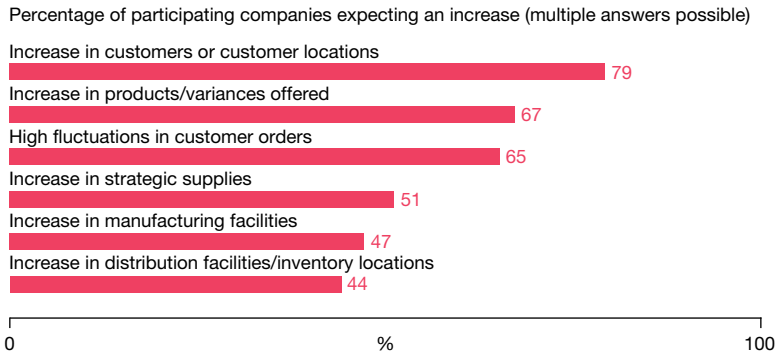
Supply chain management (SCM) has come to the fore as companies seek out more effective ways to manage uncertainty and volatility through the crisis. A key market opening for banks has been providing finance for early payment of suppliers, which has allowed companies to extend their payment terms, while still allowing suppliers to sustain liquidity. The still largely untapped opportunity is to help clients develop an end-to-end SCM network that brings in their customers and provides more informed and collaborative ways to forecast demand, open up markets and develop new products.

Our 2011 supply chain trend study highlighted how the scope of SCM is now expanding to helping companies to quickly anticipate and adapt to variations in customer demand.[13] As Figure 3.6 outlines, more than half of participants are looking to include joint planning with customers within their SCM, compared to only around a third in 2010. Demand sensing and real-time planning and execution are also now coming to the fore.

13. PwC PRTM Management Consultants interviewed 150 executives for Global Supply Chain Trends 2011.

Most survey participants expect that future business growth will come primarily from new international customers and products that are customised to meet their needs. As a result, more than 85% of companies expect the complexity of their supply chains to grow significantly (see Figure 3.7). Specifically, more than three-quarters of respondents expect an increase in the number of international customer locations, and more than two-thirds expect a higher number of products or variants will be required to fulfil customer expectations and counter shrinking revenues.

Figure 3.7 Drivers of increasing SCM complexity



Source: PwC

New SCM model

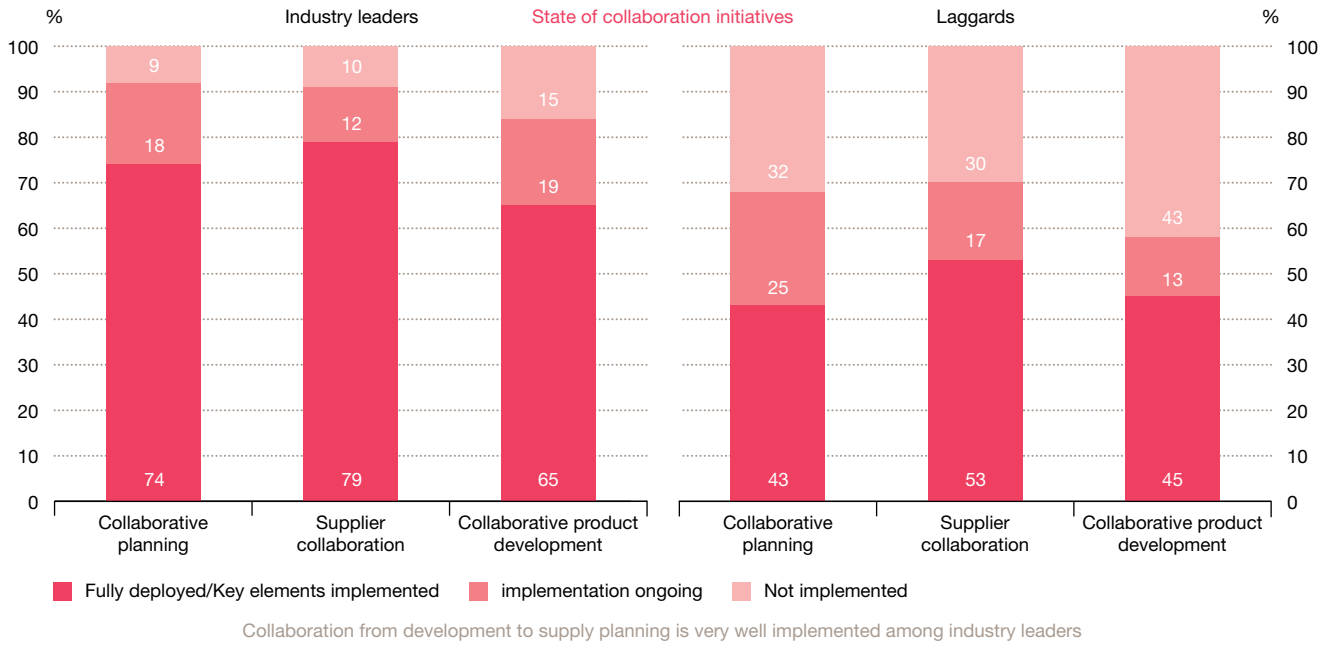
The response from leading companies is an end-to-end approach to SCM in which companies work with their main customers to gauge changing demand and then carry out joint planning with suppliers. Half of participants in the SCM study are now looking to implement real-time planning with their customers. As Figure 3.8 highlights, leading companies are taking this end-to-end approach to SCM one stage further through collaborative product and market development. The key advantage is a sharper and more responsive planning cycle and therefore no need to scramble around trying to meet unanticipated changes in demand.

The bank opportunity

Most banks have so far confined their offering to financing the physical supply chain in areas such as factoring and reverse factoring. The development of end-to-end SCM opens up further opportunities for banks.

Banks are uniquely placed to create the connections, networks and demand insights needed to extend SCM and meet client needs. This includes helping them to develop the financing options and payments infrastructure to move into new markets. The resulting SCM solutions can, in turn, open up cross-selling openings in areas such as FX hedging and asset-backed lending.

Figure 3.8 End-to-end collaboration takes hold



Note: Industry Leaders are leading in one or more key practices and belong to the top 20% of participants realising revenue benefits. Laggards are lagging behind in one or more key practices and belong to the weakest 20% of participants in realising revenue benefits.
Source: PwC's PRTM Management Consultants.

Emerging partnerships in regional banking

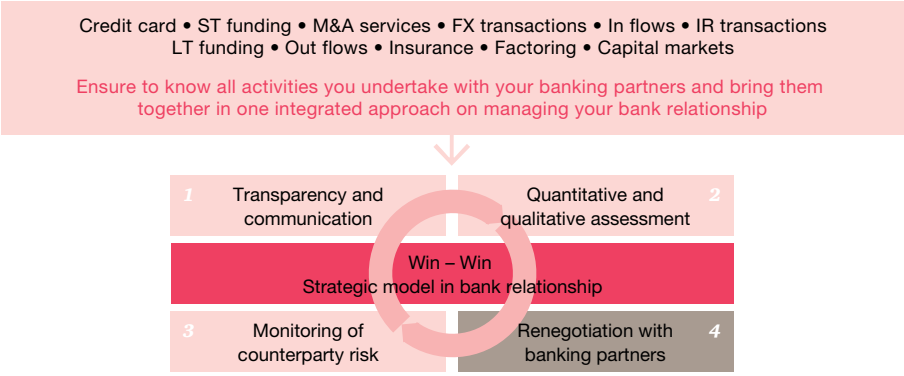
As corporations reach into new and unfamiliar markets, banks are developing new regional partnership models to serve their clients more effectively. What are the partnership options and how can they be most effectively deployed?

Although corporates are looking to be more bank-independent in terms of finance and operations, they are increasingly looking for regional support from their banks.

Indeed, the traditional, global, 'one-bank-fits-all' approach is rarely pursued by large corporates, due to the inherent concentration of financial, operational and counterparty risks this entails. They now tend to want regional support from their banking partners – banks that can provide transaction banking, financial support, acquisition advice and other key services on the ground (Figure 3.9 highlights the various elements making up the new 'holistic' relationship). This approach fits well with how large banks are themselves organised, with regional decision and customer service centres (credit risk and transaction banking, including trade finance operations). In turn, strong regional banks that meet large corporates' regional requirements could gain an important competitive edge as greater coverage could secure the client.

Figure 3.9 Bank relationship – a holistic approach

Looking at your bank relationships requires a holistic approach – the same as applied by the bank on you



Source: PwC

Corporates are demanding a strong regional banking offering and are now analysing the strength of a bank's proposed partnership model.

Figure 3.10 Key considerations for partnership approaches

Considerations for developing partnerships with other banks and engagement models to apply across various dimensions

Key considerations	Geographic dimension	Product dimension	Services dimension
• Length of the partnership • Number of customers served via the partnership • Service level agreements in place • Electronic banking system philosophy for performing operations with the partner bank • Online visibility of partner bank information • Need for partner bank accounts • Value dating practice • Customer service model • Standardised account-opening forms • Automated cash centralisation between the two financial institutions same day and end-of-day	Examples • Tacit non-competition agreement in certain countries • IBOS partnership	Examples • Cash and cheque deposits • Credit cards	Examples • Access to local clearing house • Cheque printing • Lock-box services

Source: PwC

Weighing up the pros and cons

No bank can be everywhere, and so partnerships with local banks are often indispensable. Before engaging with a regional bank's proposed partner banks, corporates will analyse the depth and effectiveness of these arrangements (see Figure 3.10), as well as the implications of working with a partner bank, either directly (e.g. 'no-competition model'), or indirectly (e.g. 'product and service cooperation').

We have identified two main regional partnership models and their potential implications:

1. No-competition model

In this model, the regional bank sets up tacit or formal agreements with local banks in those places where it has no presence. This model can be attractive if the regional bank is then able to offer complete regional coverage with a limited number of partner banks (ideally, one).

The challenge for regional banks is to find a partner that isn't likely to be a competitor, but still has the credit rating and operational capabilities to meet their customers' needs. The choice is whether to continue as the contact point for the customer and pass instructions on to the partner bank or recommend a local institution and let them deal with the customer direct. Providing constant customer contact is likely to bring a greater competitive edge, especially if the bank can ensure a smooth, seamless service and deal with any relationship issues.

The challenge for the corporate is to work with a partner bank that may not be part of its core banking relationships. These banks may therefore be unwilling to go beyond supporting the client's cash management requirements by offering credit facilities (e.g. local guarantees, technical or overdraft credit lines). Moreover, if the partner bank doesn't want to participate in wider group funding, the situation may create tension in the other areas of the banking relationship.

2. Product/service cooperation model

In this partnership model, the regional bank establishes a physical local presence, typically with only one branch, and directly services all the corporate's electronic payment needs as well as providing it with local finance support. Paper-based, country-specific requirements like cheques and cash deposits are then serviced by a local partner bank with a strong local presence, without the corporate needing to open an account.

The quality of the partnership may differ, depending on the country (and partner bank). Sometimes, the regional bank will compete with the partner bank for domestic local electronic operations, and this could actually impair the partnership. Also, the regional bank may have a limited ability to provide extensive in-country finance due to local regulations. This means that the corporate has to work with a local bank to satisfy its finance needs in any case.

Entering new markets – new opportunities for servicing existing clients

The past few years have seen an increasing trend for global companies to shift their Asian regional headquarters to mainland China. As a result, companies are looking to have the right treasury and cash management foundation in place to allow them to execute their regional business strategy. How can banks support and adapt their own business focus to these moves? We explore the implications for foreign banks operating in China and focus in on how Japanese corporates are responding to the growth challenge – and how they can be supported by their banking partners.

Developing a dynamic and flexible treasury function and planning ahead are important factors in an environment such as China's, where ever-changing market conditions and constantly shifting regulations are prevalent. As more and more international groups establish regional headquarters in China, there will be a growing need to shift the primary focus of treasury operations from transaction processing and reacting to ad hoc needs to a more strategic approach, which is flexible, automated, standardised, well planned and business focused.

Many companies see the transformation of their China treasury function as central to their regional growth plans, allowing them to foster closer connections to their Asian business operations and demonstrate added commitment to the local economy. While there are still myths in the market that 'it's China (or it's Asia) so it's different and/or it cannot be done', significant developments over the past five years have enabled companies to successfully transform the role of their local treasury operations.

Most notably, the growing number of shared service centres (SSCs) in China and Asia – including locations such as Singapore, Hong Kong and more recently, Malaysia – have allowed much of a treasury's transaction processing function to be captured through these SSCs. Input from the company's global treasury function has also been an important factor in helping to determine how best to support a business as it shifts its strategic focus.

Working with the RMB

As China continues to experiment with loosening regulatory restrictions related to the renminbi (RMB), companies are able to do more with the currency to support their business growth, manage costs, and promote efficiency and effectiveness. This is evident in the number of cross-border trade-related transactions being settled in RMB rather than US dollars (USD).

This ongoing change has caused companies to re-evaluate the role that the currency plays in its business, not just within China, but also globally. Using the RMB can release a range of potential benefits, including:

- Improving top-line revenue with customers that prefer the RMB.
- Improving the cost structure of deals with suppliers that prefer the RMB (but have historically priced in USD with a 5–25% 'cushion' to compensate for expected depreciation).
- Altering the company's foreign currency risk profile to better manage risk through global treasury centres.
- Supporting and aligning with the agenda of the State Administration of Foreign Exchange (SAFE).
- Reducing complexity in foreign exchange (FX) processes.
- Reducing the number of currencies to better manage in-country liquidity.
- Winning Within the Banking and Regulatory Landscape.

China's developing banking landscape

While there has been much progress, China's banking and regulatory landscape is still in its development stage and leading companies are using the best that the international and domestic banks have to offer, while also having a targeted regulator relations programme.

The electronic banking (e-banking) system, relatively low international bank penetration, complex manual regulatory requirements and legacy practices typically mean that most companies have to use many banks in China. However, many look to streamline the number of bank partners to two to three banks for the whole country, which is a difficult task to accomplish.

Domestic banks have a much larger branch presence in China, greater access to capital via their deposit base, and the ability to effectively work with SAFE – the state agency that sets FX policies along with its other functions. However, these domestic banks are still developing their services and extending technology, customer support and relationship management models. This, coupled with the fact that a domestic bank's branches are not closely tied together – much as though you are dealing with a completely different bank – creates a challenge for companies used to working with more integrated international banks.

Local Chinese banks are eager to grow internationally and are keen to lend to multinationals, which the latter are often using to their advantage. As the PwC's 2012 'Foreign Banks in China' survey notes, international banks still have a share of below 5% of the Chinese market. But they are typically much better known in China than local banks for their products, technological sophistication, relationship management, transparency and global expertise, and can therefore better enable standardisation and efficiencies within the country and across borders.

It's also crucial for businesses to cultivate a good relationship with the local regulators, and in the Chinese context, particularly with SAFE. The government appears inclined to experiment with new liberalisation policies, and working closely with SAFE may provide a better perspective about the regulator's expectations.

Performance of foreign banks in China

Foreign banks experienced their most profitable year in China during 2011. This strong result arose despite the subdued outlook for the Chinese and global economy, limiting opportunities for growth. Foreign banks have benefited from a range of opportunities including trade finance, treasury, foreign exchange, commodity financing, fixed-income products, bonds, etc. Foreign banks envisage continued revenue growth, with most expecting an increase of 20% or greater in 2012 and around three-quarters of respondents expect this annual rate to continue through to 2015.

Growth options are limited by loan caps imposed by regulators and relatively slow branch approvals. The focus is moving to new channels and customer segments, e.g. state-owned enterprises (SOEs) and privately owned enterprises (POEs), calling for a larger workforce with dedicated local experienced relationship managers. Trade finance and cash management services are fuelled by firms expanding offshore (see the example of Japanese corporates) and foreign banks are particularly well positioned to assist these firms through their established global networks and trading expertise.

Access to funding remains a key challenge for foreign banks, with their lending activities heavily dependent on deposits. Foreign banks are focusing on growing corporate deposit books and predict a diminished reliance on parent companies, together with a greater proportion of corporate deposits to finance activities. Foreign banks are also keeping pace with the expansion plans of multinational corporations based in China. Many are shifting their operations away from manufacturing exports towards production, distri-bution and marketing products for the local market. China's build-up of innovation-focused industries is creating new opportunities for foreign banks. Foreign firms are increasingly acquiring or partnering with local companies seeking to develop new technologies and build R&D capabilities. They are seeking financiers with expertise in these industries and can provide solutions in terms of cash management, investment and financing activities.

The market remains competitive and foreign banks face particular challenges in relation to retaining employees – they believe they tend to operate as training institutes, often losing staff to new foreign banks setting up operations. Similarly, salaries are rising in an attempt to protect against the loss of senior well-qualified staff.

Managing cash and liquidity

Corporates entering China typically have significant growth plans, new plants, new acquisitions and joint ventures in mind, plus they want a broader country footprint, and face evolving business, regulatory, political and social environment and cultural norms. All this makes for a difficult task for treasuries trying to forecast and optimise cash and liquidity.

China's heavily regulated environment typically means more time is needed to react and, coupled with its market dynamics and the limited financing tools available, short-, medium- and long-term cash forecasting becomes critical. The objective is not so much to predict cash flow with a high degree of accuracy, although that would be helpful, but to understand the range of potential scenarios so that management can make more informed decisions and alternative investment and financing plans, and have better flexibility to respond, for example to minimise trapped cash build-up.

The number and type of bank accounts, collection and disbursement techniques are all levers used by leading companies. Having more accounts and relationships raises complexity and cost, and reduces a company's level of visibility, transparency and control.

Bank account structures are often unnecessarily complicated at many multinational corporations and typically the result of different regulatory environments and market conditions. Realistically, companies can be effective with a few disbursement accounts and, depending on the industry, a number of collection accounts. The 'wild card' is the number of accounts for tax payments and the special accounts for loans and other capital type accounts. Also, the more business one can do in RMB, the more streamlined the account structure and number of banking partners can be.

Bank acceptance drafts (essentially post-dated cheques) are also common practice in certain industries, and their use increases or decreases with the state of the economy and the availability of bank funding. Leading companies manage them effectively with a clear policy, given the associated working capital, finance and risk dimensions. Finally, the high growth of credit and debit cards is changing the payment landscape rather quickly and is being leveraged by forward-looking companies.

Similar to other countries, a cash pool-type structure is a key tool available in China. Generally, pooling is allowed only when operating within the same legal entity. Since the People's Bank of China's (PBOC) general rules for lending prohibit intercompany lending between non-financial institutions, entrustment loans can be used to work within such rules. Effectively, RMB or foreign currency pools can be set up through an entrustment loan framework, which allows funds to move from one company to the other, with a bank acting as an agent for which they charge a fee.

These entrustment loans can also be used, at times, on a cross-border basis to funnel excess liquidity to other parts of the world. While these cross-border loans will eventually need to be repaid, they can help to meet temporary cash needs. However, historically, there have been onerous regulatory barriers to obtaining SAFE approval.

Japan confronts the new realities

Japan was probably the first advanced economy to have to confront the challenges of 'maturity' in areas ranging from an ageing society to how to transform a mature economy so it can thrive in an increasingly complex global business environment. How the country tackles these challenges will serve as models for the world. That is not to say the answers to the new global questions will come easily. All nations must weigh their current advantages and circumstances in the face of new global realities, which include:

- The arrival of Asia as the engine of the world's economic growth is producing fierce, new competitors. However, a new middle class of Asian consumers gives Japan an opportunity to secure its niche market advantages.
- Growing connectedness between economies and more complex trade and financial relationships necessitates updated management approaches.
- New models of innovation boost competitiveness and help capitalise on diverse ideas and efforts to support new and better product development and manufacturing.
- Restructuring domestically focused businesses as well as addressing Japan's ageing workforce and need for skilled human capital are important for greater national prosperity.

These realities give rise to a series of business implications. How must Japanese corporations adapt to these business implications? Armed with a change in attitude, we believe there are four key themes for the decisive change Japanese corporations require:

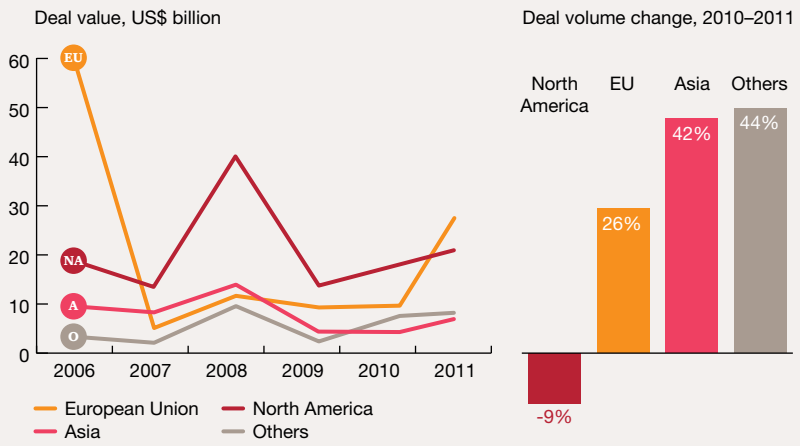
1. Transform the organisation – leaders need to champion major organisational change to enable their companies to succeed in today's world. Japanese corporations need the talents and fresh perspectives of a wider group of people; throughout the organisation and in the governance structures are needed. Japanese women, foreigners, mid-career hires and the young generation are all groups that bring a huge amount of energy and a multitude of ideas. Japanese corporations that embrace these groups will find they are better able to win against both domestic and foreign competitors.
2. Adapt innovation – open up the organisation to accelerate innovation. Put yourself in the place of an outsider – perhaps an entrepreneur, small business owner, or foreign multinational corporation – with a good idea, technology, or even a network that will advance the aims of your business: How easy is it for these potential partners to work with your organisation and find the right people? For most Japanese corporations, the answer is, not easy at all. Japanese corporations are going to have to use new approaches like 'intrapreneurship' and 'co-creation' with outside organisations to re-energise the innovation processes required to be global leaders.
3. Grow your leadership pipeline – understand the full range of capabilities required to successfully lead in today's world. Corporations need to make changes to promotions, training, rotation and compensation which will produce more leaders who are in tune with the four realities. Companies should open themselves up to more merit-based promotion and external senior level recruitment in order to foster the type of leaders who are not risk-averse and have the skills to confidently guide their organisations in new directions.
4. Focus your growth strategy – many Japanese corporations can become more aggressive, with options including M&A activity, direct investment and partnerships. As of yet, domestic markets have not rationalised, conglomerates continue to be in too many businesses and corporations continue to be wasteful of capital. The objective is to focus more effort on opportunities that will deliver the type of value-added activities Japan needs in markets that are growing.

For Japan, there are specific areas where focused effort can produce real and lasting competitive business advantages. On the whole, Japanese corporations must do more to adapt. To be sure, many Japanese corporations are doing lots of the right things, and some are doing many of the right things – but given the enormous size of the Japanese economy, not enough companies are adapting fast enough to transform and thrive in the future.

Japanese companies have recently ramped up their acquisitions across Asia. In 2011, Japanese deals in the region rose 42% compared to a 25% rise in deals in Europe and a decline in North America. Small and medium-sized Japanese companies are participating in the deal flow – focusing on factories and heavy industry, in the middle of the global supply chain. However, Japanese corporates are facing heavy competition in these new markets (e.g. from Korea in automobiles and electronics) in terms of their historic dominance of high-tech, innovative products.

Figure 3.11 Change in Japan's outband M&A, by destination

Outbound M&A has grown accompanied by an increasing focus on smaller acquisitions in the last year; however, investment in Asia and other emerging regions still lags investment in more mature markets.



Source: Revitalising corporate Japan, PwC, 2012

Funding growth

Within China, external financing vehicles for foreign multinationals are still limited and very much dominated by traditional bank loans, set at PBOC rates. The simple procedures for originating such loans are a major reason for their popularity. Various segments of the capital markets including the sale of commercial paper and long-term bonds are continuing to grow, but foreign companies are currently restricted from using them as financing vehicles.

These markets are slowly opening up, however, and might see some changes within the next few years. 'Panda bonds', or bonds issued by foreign companies within China, and onshore equity listings, for example, are currently under discussion for multinational companies. Other vehicles such as project financing and leasing do not appear to be popular, mainly because of strict limitations and the lack of clarity on the range of legal and regulatory complexities.

As Beijing pursues the gradual process of internationalising its currency, Hong Kong has become a key platform for issuing RMB and RMB-denominated products. In particular, RMB-denominated bonds in Hong Kong, or 'dim sum' bonds, are gaining in popularity and have been used by a number of multinational companies.

Finance companies

Finance companies, as defined by the China Banking Regulatory Commission (CBRC), are relatively new in China and are a type of business licence that can further enable more efficient and effective treasury management. Finance companies are non-bank financial institutions that provide financial management services, common to a typical centralised treasury, to the group's member entities.

These services include FX transactions, entrustment loans, accepting/discounting bills and deposits, settlements and providing guarantees, to name but a few. However, a finance company is strictly regulated by the CBRC and faces stringent compliance and reporting requirements. Only companies with a sufficient amount of scale and financing need consider them worth the extra time and effort.

Alternatively, some companies establish a regional headquarters (RHQ), or a Chinese holding company (CHC), two other vehicles that can benefit treasury. An RHQ can play an active role in centralising the regional treasury by taking advantage of favourable local policies, whereas a CHC can help enhance group cash management, as it can achieve cash concentration via the entrustment loan arrangement. Multinational companies commonly set up a CHC to hold various investments, and can enhance tax efficiency where dividends are distributed.

Managing treasury in China is by no means easy, but thoughtful consideration and evaluation of your company's situation along with a willingness to change can yield substantial benefits.

Corporates entering China face a challenging time forecasting and optimising cash and liquidity - banks need to be well positioned to help provide insight and support growth plans.

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