Banking and capital markets

# Operating in the future

## Is your operating vision clearly defined?

PricewaterhouseCoopers

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# Executive summary

The future started yesterday. With bank revenues increasing again, particularly in investment banking, there is a danger that the lessons learned in the stress environment created by the financial crisis will be forgotten and structural issues within both the industry and individual institutions will be put to one side, only to resurface in the next crisis.

PricewaterhouseCoopers[1] analysis shows that structural failings within operating models, whilst exposed by the financial crisis, were clearly visible pre-crisis. The balance between short-term maximisation of Return on Equity (RoE) and the controls, processes and systems that should have created a focus on sustainable profit was lost. In conceding this point we have to accept that, regardless of changes to business strategy, the operating models that deliver the strategy will need to undergo structural change.

The case for this change is strong:

- Pre-crisis improvements in operating efficiency, when measured by cost/income ratios, were frequently achieved through growth in revenue – largely as a result of increased leverage and/or exposure to wholesale funding, rather than structural changes to the operating model or cost base.
- The effectiveness of pre-crisis operating models in providing appropriate governance and control failed in many cases.
- Post-crisis, the regulator will seek additional input and oversight of operating models.

Going forward the increased costs of capital and liquidity will have an impact on both revenues and profitability in the industry, therefore structural changes will be required to achieve the necessary efficiencies that can drive acceptable levels of RoE.

‘regardless of changes to business strategy, the operating models that deliver the strategy will need to undergo structural change.’

Whilst the appropriate alignment and sourcing of delivery capabilities (channel, operations and technology) is key, operating model considerations are far wider, and must also consider governance and risk, financial performance and management, physical and legal structure and people and reward. As such, when designing a future operating model it is important that components such as performance management, risk management, tax efficiency and reward are embedded in the architecture of the business and not bolted on as an afterthought.

1 ‘PricewaterhouseCoopers’ refers to PricewaterhouseCoopers LLP (a limited liability partnership in the United Kingdom) or, as the context requires, the PricewaterhouseCoopers global network or other member firms of the network, each of which is a separate legal entity.

To find the correct solutions it is vital first to ask the right questions. Chief Operating Officers and their Chief Executives need to consider the following points:

| Key question | Other areas to consider |
|---|---|
| 1. Is your customer value proposition optimised for the new market reality and is your operating model aligned to deliver it? Will it drive acceptable levels of RoE? | • Is your customer proposition fully understood across the organisation and are the appropriate controls in place to ensure alignment of business ambition to risk appetite?<br>• Given higher capital costs, should credit relationship still be the primary driver of segmentation, or are there more sophisticated needs-based approaches that would improve performance?<br>• As liquidity eases, what will your response be to regulatory interventions around customer acquisition and associated pricing models? |
| 2. Does your delivery capability align to the business model, or are channel, operations and technology strategies developing in isolation? | • Do you know the unit cost and profitability for each channel and customer segment? How do you make decisions in the absence of such information?<br>• How agile are your operations and technology? Will they provide you with the adaptability needed to meet changing market and regulatory demands?<br>• Do all aspects of your value chain (channel, operations and technology) need to remain in house, should they be outsourced, or could they be facilitated through white label solutions? |
| 3. Is your operational vision clearly defined, consistently communicated and fully embedded across your organisation through bank-wide policies, risk management procedures and other controls? Furthermore, are these policies, procedures and controls adhered to when they clash with the business model? | • Can you clearly articulate what risks the business is exposed to and who is managing (rather than just monitoring) these risks?<br>• Do you have the right people in place, with relevant skills and the appropriate resources to allow you to manage risk?<br>• Are your risk functions and senior risk officers sufficiently empowered to ensure that all key risks are brought to the attention of the board and not ignored?<br>• Are key individuals in the risk process sufficiently accountable for decisions that are made? |
| 4. Have you assessed where your current financial and performance measures are appropriate, inappropriate, or simply missing? | • Do you manage the business to a defined set of constantly evolving scenarios (both positive and negative) which reflect your commercial and risk position relative to the changing market environment?<br>• Do your financial and performance management procedures provide you with an understanding of return on economic capital, highlighting where value is being created or destroyed?<br>• Given increased scrutiny by the regulator, how will the business balance both current and future risks against the imperative to make acceptable shareholder returns?<br>• Do your existing systems provide a clear view of the drivers of RoE and allow you to communicate them effectively to the market? |
| 5. Does your legal and physical structure position you in an optimal way to take full advantage of new market opportunities, whilst preparing you for possible regulatory interventions that will fundamentally change the way you operate? | • What is the geographical footprint that will be required to service new market opportunities, tap into new sources of capital and optimise your tax position?<br>• What steps have you taken to address the possible regulatory requirement to separate investment banking and retail banking, including legal entity challenges and living will proposals?<br>• How will you optimise value to the business whilst balancing your response to regulatory interventions around complex legal, liquidity and booking arrangements? |
| 6. What are the core values of your brand, how embedded are these across your organisation and how will you win over the hearts and minds of your people to deliver them? | • What are the skills that will be required to drive your vision, manage your risk and differentiate your business in the marketplace?<br>• How will you regulate risk and reward whilst encouraging cross-functional collaboration? |

The evolution to a new operating model will require substantial change, not limited to processes, systems and controls. Recent PricewaterhouseCoopers analysis demonstrates that institutions with high-performing operating models benefit just as much from cultural factors brought about by strong leadership and effective communication.

A road map for change, which may include significant cultural re-focusing, must be clearly articulated and sponsored at the highest level. The principles that underpin delivery of the bank's business proposition must be clear and the implications fully and consistently understood at all levels across the organisation.

# The case for change

# THE STRATEGIC CHALLENGE



Driven by dramatic shifts in the market brought about by the financial crisis, the banking environment has changed significantly. The impact of this change is complex and the realities are only just beginning to be fully understood. In our 2009 paper 'The day after tomorrow', we summarised the crisis into seven key themes, with associated imperatives for businesses to consider:

| Theme | Imperatives |
|---|---|
| **Monetary vacuum**<br><br>Capital, credit and liquidity vacuum | • Grasp consequences (including unintended ones) of deleveraging.<br>• Refresh perspective on sources/uses of all types of financing.<br>• Only allocate scarce funds (capital/credit/liquidity) to truly distinctive institutional capabilities. |
| **Classic banking renaissance**<br><br>'Nouveau Classic' banking models replace unsustainable, over-leveraged structures | • Undertake business-model-led-portfolio and cost reshaping.<br>• Create divestment execution capability.<br>• Develop a holistic view of risk and return on risk.<br>• Closely align rewards with better-designed corporate objectives. |
| **Never again**<br><br>Pursuit of 'zero-risk' regulation by the G20 and beyond | • Establish new frameworks of engagement with government and regulators and possibly gain competitive advantage. |
| **Rising powers**<br><br>Global realignment towards the East | • Challenge and adapt strategy given new basis of competition. |
| **Unprecedented fiscal pressure**<br><br>Tax burdens and national debt rises, particularly in the US and UK | • Work out intelligent responses to government pressure. |
| **Government inside the tent**<br><br>State control in the financial markets will grow, changing competition dynamics | • Understand market dynamics with the emergence of state-supported banks (SSBs).<br>• Adapt to and anticipate SSB approaches to governance, tax, dividend policy, compensation etc. |
| **Strategic foresight**<br><br>From survival mode to sustainable competitive advantage | • Rebuild trust and confidence among all stakeholders (and keep it).<br>• Build robust approach to cope with a sustained level of uncertainty.<br>• While the global marketplace environment has changed, remember that many of the underlying forces shaping the future of financial services have not changed. |

Source: The day after tomorrow, PricewaterhouseCoopers, January 2009

Whether an emerging winner, or simply a survivor, each institution needs to address fundamental questions concerning the impact this new commercial environment will have on their organisation; such as new and emerging trade corridors, capital shifts, changes in the locus of business, or increased dialogue with the government and the regulator. Specifically, two key questions regarding strategic direction must be answered:

- Where is value created and destroyed in the business?
- Is the business in the right markets and positioned to take advantage of future growth opportunities?

What is clear, however, is that for many institutions, regardless of any changes to their business strategy, the way that strategy is delivered – i.e. the operating model – will have to change. This need for change is based on:

- A broad definition of the operating model that aligns sustainable profit to operating model performance;
- A hypothesis that bank operating models have been historically weak, but that these weaknesses have been masked by exceptional revenue growth and a relatively benign pre-crisis regulatory environment; and
- An indication that emerging regulation will scrutinise operating processes/organisation/structures to the same degree as capital.

The impact on operating models will be significant, not simply to ensure compliance with emerging regulation, but to allow organisations to counter the negative forces impacting return on equity (RoE).

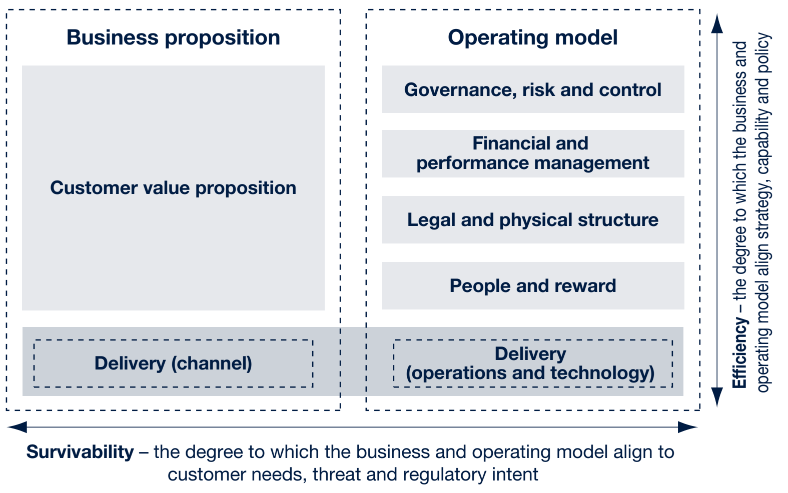
In this environment institutions must consider not simply the efficiency of the operating model but its effectiveness and the degree to which it can survive. The question of survivability has already triggered a number of reviews of core/non-core businesses at some institutions, but carving out non-performing assets is insufficient. Assets considered for disposal are usually identified by the ease with which they can be carved out, their distance from the centre and their immediate market value – none of which suggests that their disposal addresses operating model failings of the remaining core. Instead, institutions must accept that historical problems with governance, control, cost and overall performance management need to be addressed.

**The business model**

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

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

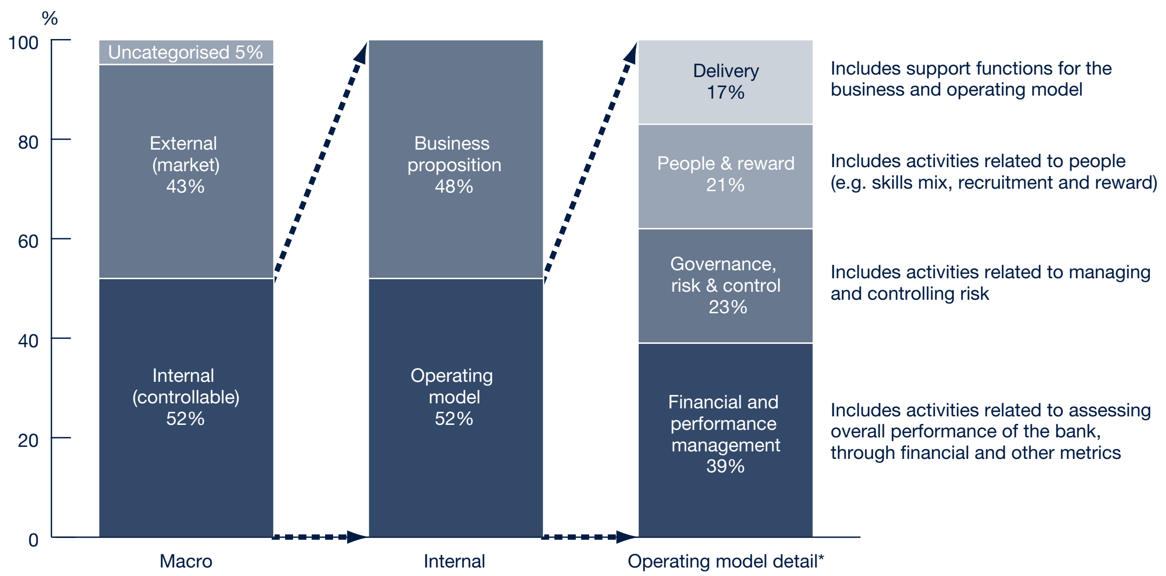
**Components of the business model**




Source: PricewaterhouseCoopers analysis

PricewaterhouseCoopers analysis[2] into the reasons behind pre-crisis bank share price falls larger than 5% (for 14 top global banks over the period of 1999-2006) showed that approximately 52% of large share price falls were triggered by internal controllable factors, of which just over half were driven by operating model factors.

**Reasons for share price falls >5% (1999-2006)**




* Legal and physical structures (i.e. the legal structure and physical location of the bank) were not included in this analysis

Source: PricewaterhouseCoopers analysis, Spring 2009[2]

2 PricewaterhouseCoopers researched and classified the key reasons which drove one-day share price falls greater than 5% (Source: Bloomberg) at 14 top global banks of Western origin over the period 1999-2006. This was achieved by first identifying the share price falls and then researching the key announcements and/or analyst opinions of the reasons behind those share price falls. The data shown in this paper is the cumulative result obtained for all banks analysed.

# LONG-TERM LOSS OF CONTROL DRIVES THE NEED FOR CHANGE





It is important to recognise that the financial crisis did not cause operating model failure. Instead, the stress environment that was created exposed longstanding weaknesses, which in turn contributed to the financial crisis. There are several high-profile examples of operating model stress, where early warning signs of the crisis were either ignored or not addressed appropriately by leadership.

In an effort to address why the industry was unable to withstand the market turmoil, PricewaterhouseCoopers conducted analysis into the core performance of 14 global banks over the period 1999-2006 to establish the sustainability of banking businesses and their associated operating models. This analysis shows that weaknesses existed in bank operating models prior to the crisis, which were then exposed on its arrival. An essential element of the operating model is the efficiency with which it generates value, in the form of sustainable profit, for the shareholder. The current financial crisis has highlighted the degree to which banks' operating models lost control of emerging business propositions. For example, the way business growth plans were developed and driven whilst disconnected from risk appetite models; the way warnings from control staff were ignored by the business; and the way in which boards lacked the confidence or insight to challenge the executive.

How was this allowed to happen? The reality is that the pre-crisis regulatory environment was relatively benign. Combined with an exceptional period of revenue growth, which had become disconnected from both long-term revenue growth trends and long-term relationships with growth in GDP, this created a false sense of security.

**The underlying problem**

Short-term bank revenue growth became disconnected from both long term revenue trends and its historical relationship with GDP

**Long-term vs. short-term trends in bank revenue and GDP growth**

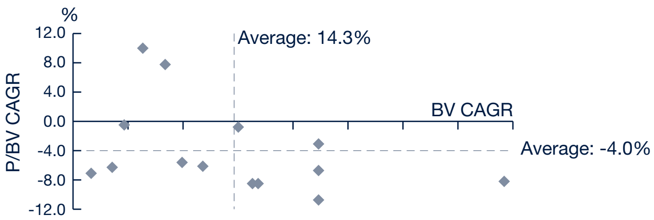
| | Long-term (CAGR) | Short-term (CAGR) |
|---|---|---|
| Bank revenue growth* | 8.6%* (1934-2006) | 10.5%** (1999-2006) |
| GDP growth | 8.1% (1960–2006) | 6.7% (1999-2006) |

* Based on average revenue growth for US commercial banks
**Based on average revenue growth for 14 top global banks of Western origin

Source: Bankscope, US Federal Reserve, World Bank, PricewaterhouseCoopers Analysis, Spring 2009

This occurred in part because of growth in both bank balance sheet and leverage positions; however this growth was not rewarded by the market

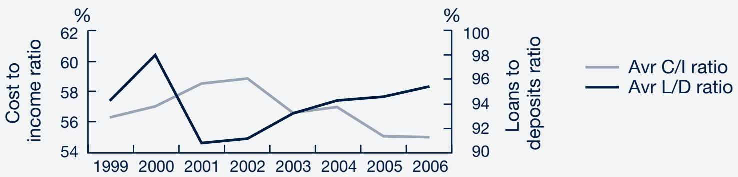
**Comparison of growth in BV to P/BV, 1999-2006**




Source: Bankscope, US Federal Reserve, World Bank, PricewaterhouseCoopers Analysis, Spring 2009

Although this situation allowed banks to communicate improvements in operating efficiency (when measured by cost income ratio), the efficiencies claimed were not structural in nature and underlying operating issues were exposed by the onset of the financial crisis

**Cost to income and loan to deposit ratio for 11 banks***, 1999-2006**




*** Average, excluding investment banks

Source: Bankscope, PricewaterhouseCoopers Analysis, Spring 2009

Banks were able to report improved operating efficiency year on year, when measured by cost/income, creating an illusion of both effectiveness and efficiency. In reality cost/income ratios were not a reflection of operating efficiency but leverage and in some cases increased exposure to liquidity risk.

This will not be the last crisis we experience. Ensuring that failures in bank operating models are addressed is critical to ensuring that banks are not the next victims of future market stresses. This raises two further fundamental questions, which winners in the new market will have addressed:

- Is the operating model adaptable enough to take advantage of new market opportunities and robust enough to avoid future failure?
- Is the business making the right investments to support this?

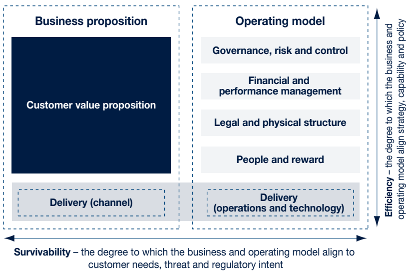
Signs of 'green shoots' alongside improved results from the financial sector may have given the impression that the issues in both the business and operating models have been resolved, which is not the case. Further, political and media scrutiny has also been directed towards a small subsection of issues (notably bank reward) and this focus has diverted attention away from some of the fundamental problems still affecting operating models. In reality lower leverage and higher capital costs will impact profitability in the long-term in an environment where regulators are empowered and more active.

In summary, exposed by the financial crisis, longstanding issues in bank operating models were undoubtedly key contributors to some of the most high-profile bank failures of the past two years. Leadership must ensure that they are protected from future crises by categorically resolving these issues now. Institutions must rethink their business propositions and the operating models that deliver them. History has shown us that boom and bust cycles are likely to continue; therefore banks need to ensure that they avoid being in the wrong place at the wrong time when the next crisis hits. Achieving this will in part will be down to great leadership and strong management practices; however they will only be truly effective when supported by a robust and fit-for-purpose operating model.

# Understanding the problem

# THE BUSINESS PROPOSITION






Over the last 18 months we have seen significant change in demand for financial products and services. These changes have come about quickly and it is not clear when and if the market will return to its former state, whether it will continue on this new course, or whether we can expect further unforeseen disruption. In the short-term we have experienced:

- An increased focus on risk-return;
- A focus on 'safe' products;
- Increased demand for alternate sources of credit (e.g. leasing and invoice discounting); and
- Decrease in demand for exotic/complex products, driven by a combination of attitude to risk and regulatory intervention.

Banks need to reassess fully current and future customer needs, and for most institutions, client-centric approaches around mature, low risk, volume-driven businesses will be a central part of the strategy.

As the cost of capital and liquidity increases, a fundamental repricing of balance sheet usage will occur. Sophisticated banks, however, will think beyond repricing and look at the underlying segmentation of their customers to seek out areas of profitability that are less dependent on capital consumption. The long-term trend in the industry away from net interest income (NII) to non-NII revenue sources (non-NII revenue rose from about 20% of total revenue in 1980 to about 43% in 2000)[3] is likely to continue.

As this occurs current segmentation and relationship models should be challenged. Customer segmentation models are traditionally broken down by geography, turnover or income, and industry group or demographic. But this type of segmentation originated from a credit-based relationship. Winners in the new market will have sophisticated customer segmentation models and a value proposition based on servicing the needs of these various segments. In future we expect to see leading banks:

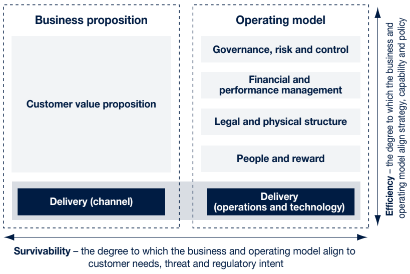
- Revisiting pricing to match new customer segments;
- Demonstrating added value to their customers (both individuals and institutions) and improving service levels to customers;
- Empowering sales personnel to cross-sell products and services;
- Making decisions based on deep customer insight; and
- Creating reward and recognition models that recognise a balanced or risk-weighted approach to customer relationships.

**Key questions for leadership:**

Is your customer value proposition optimised for the new market reality and is your operating model aligned to deliver it? Will it drive acceptable levels of RoE?

- Is your customer proposition fully understood across the organisation and are the appropriate controls in place to ensure alignment of business ambition to risk appetite?
- Given higher capital costs, should credit relationship still be the primary driver of segmentation, or are there more sophisticated needs-based approaches that would improve performance?
- As liquidity eases, what will your response be to regulatory interventions around customer acquisition and associated pricing models?

3 Source: 'Diversification in Banking, Is Noninterest Income the Answer', Kevin J. Stiroh, Research Officer, Federal Reserve Bank of New York – 23 September 2002.




## Channel

In the post-crisis environment, banks are increasingly focusing on cost containment. Challenging the existing channel mix or considering new and innovative channels to market is, therefore, becoming increasingly important.

Banks typically want to multiply contact points with the customer, giving rise to several key considerations:

- Channels with the greatest interactivity, information collection and flexibility are also the channels that are the least reachable, given location and time constraints;
- New channels are often launched without adapting the offering to the relevant customer segment that will be its major user;
- Clients are not always ready to use a channel for banking transactions;
- Often, there are no cost synergies between channels. A new channel will often create additional distribution costs, rather than lowering overall costs;
- Pricing strategies should be aligned with the level of advice provided, quality of service offered and the break-even of each channel;
- There is a cannibalisation risk between channels, which is not often understood, quantified or managed;
- Migration strategies from one channel to another are non-existent or not well defined.

Banks need to ensure that they develop a clear understanding of profitability by customer segment and channel. Assessing the profitability of channels and products for each segment ensures a multi-dimensional understanding of the institution's operations and can lead to more targeted customer acquisition and a reduction in unit customer costs.

Banks need to monitor and evaluate continually the effectiveness of new innovations in channel strategy (especially across their global portfolio of businesses). As well as new channels to market such as mobile, banks should consider the merits of pseudo channels to market such as white labelling partnerships, which could open up new markets and access to new customers.

## Operations and technology

The financial crisis has exposed the complexity and increasing inflexibility of back office operations and supporting infrastructure, which are manifested not only in process inefficiencies, but also in a lack of quality information on which to make management decisions. As these operations form the backbone of modern banking, it is vital that restructuring activities remain high on leadership's agenda.

### Infrastructure shaped by market reality

Increased complexity brought about by bespoke products, new channels and customers has meant that management have found it difficult to create standardised systems and processes. Countless workarounds, manual adjustments and exception processes have become the norm, often resulting in duplication, large non-reconciling balances and poor data quality that do not provide a 'single version of the truth' to leadership and regulators alike. This inevitably affects customers by increasing cycle times and the potential for service failures, in turn leading to increased operational risk and lost revenues.

### From 'scale and lean' to 'flexible and agile'

Several industries have experienced a sequential move from a 'cottage industry mentality', through 'automation' to 'scale and lean'. High-performing businesses, however, have now evolved further to a focus on being 'flexible and agile' which means that they are adaptable to changing market demand.

Agility is not just about technology, it is about bringing together technology, people, processes and culture as a single system that works as one. This facilitates a robust operating model that can rapidly respond to changing business needs and regulatory initiatives. At the heart of agility is business process monitoring, which enables information-driven decision making and empowers management to justify the impact of processes on client service and business growth.

In future, banks should look on agility as a key differentiator, which provides greater transparency, reduces complexity through standardisation and facilitates flexibility to respond to changing market demand.

### Outsourcing and the distributed organisation

Managing a distributed organisation, in terms of the people, technology and workflows required to support a global business is highly complex and made more difficult because of partially or fully outsourced activities.

The crisis has served as a catalyst for change in the outsourcing space, including a shift in focus on the geographic footprint for offshored services, the type of work outsourced and the nature of processes to service it.

Appropriate standardisation of processes, alongside consideration of the number of processes impacted, is critical for successful migration and is an area that has lacked focus in the past. Furthermore, many outsourcing deals have been agreed on an ad-hoc basis as a 'quick fix' or cost-cutting exercise, rather than as part of an integrated strategy. In future, increased scrutiny from regulators, alongside the need to manage the business in a more transparent way, will drive focus on making improvements in the nature and operation of outsourced activities.

### A need for targeted and sustainable investment

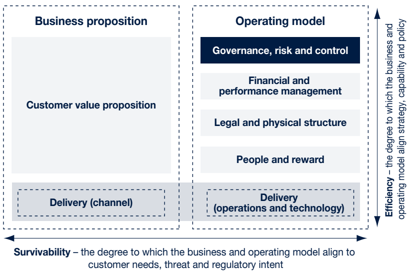
Recent market stresses have demonstrated that infrastructure was in desperate need of new investment, and as a result, large budgets are now being made available for change.

Noting that frequent changes of management can disrupt the investment cycle, there is a need to prioritise strategic projects across operations and technology in order to deliver only those that will really make a difference (there are numerous examples of ineffective programmes due to a lack of coordination and prioritisation). Additionally it is important that investments are 'joined up' and that due consideration is given to the long-term delivery of these initiatives.

**Key questions for leadership:**

Does your delivery capability align to the other constituents of the business model, or are channel, operations and technology strategies developing in isolation?

- Do you know the unit cost and profitability for each channel and customer segment? How do you make decisions in the absence of such information?
- How agile are your operations and technology? Will they provide you with the adaptability needed to meet changing market and regulatory demands?
- Do all aspects of your value chain (channel, operations and technology) need to remain in house, should they be outsourced, or could they be facilitated through white label solutions?




Governance, risk and control functions are not only central to the regulatory response, but should also be instrumental to the decision-making processes required to drive sustainable value creation. The crisis has highlighted the degree to which bank operating models failed to fully control the business risks.

'Weaknesses in risk management, board quality and practice, control of remuneration, and in the exercise of ownership rights need to be addressed in the UK and internationally to minimise the risk of a recurrence.'

The Walker Review; A review of corporate governance in UK banks and other financial industry entities, 16 July 2009

## Clarity of roles and responsibilities

In many cases, clear lines of responsibility and accountability were not rigorously defined and enforced by leadership, particularly where cross-functional processes were required or where risks crossed the traditional boundaries of credit and market. This lack of clearly defined responsibilities led to situations where decisions were often made by committee. In turn, this means there is often no clear line of recourse as individuals are unwilling to stand out and take responsibility for their decisions.

## Complexity of the risk process

Given a universal drive to meet growth imperatives, a 'cottage industry' way of working evolved, where risk was assumed to be under control. The underlying complexity of many banking products, however, made it difficult for senior executives to maintain a detailed knowledge of risk exposure. In some cases, the crisis has exposed the fact that many senior executives did not have the skills, experience or insight to fully understand the risks they were taking.

A key challenge remains in ensuring that responsible non-executives have the right skills, expertise and experience to provide an effective 'counterweight' to executive decision making.

## Embedding the risk function

The governance, risk and compliance functions have, in some organisations, struggled to gain recognition at a senior level. Chief Risk Officers (CROs), or equivalent individuals with appropriate skills, need to be empowered in risk committees and boardrooms to directly challenge other board members on unsustainable or overly risky decisions. The classic 'three lines of defence' model can only work if it is implemented properly, clearly understood and rigorously followed. This has frequently not been the case. For the CRO should control and monitor risk, they need to be positioned at the heart of key business processes and major decisions, but the heads of business must be responsible for managing risks. In general the executive and board must become as conversant with risk management as they have with financial management over the last 20 years.

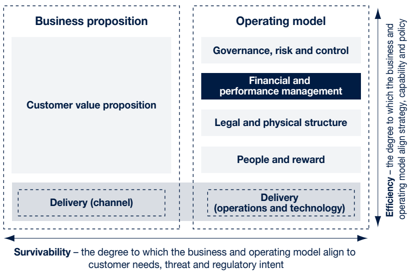
## Reinforcement of vision across complex organisations

As we move beyond the crisis it is critical that leadership consistently reinforces a clear vision across the organisation. Development of guiding principles that clearly articulate how the vision should be manifested across the organisation is key.

**Key questions for leadership:**

Is your operational vision clearly defined, consistently communicated and fully embedded across your organisation through bank-wide policies, risk management procedures and other controls? Furthermore, are these policies, procedures and controls adhered to when they clash with the business model?

- Can you clearly articulate what risks the business is exposed to and who is managing (rather than just monitoring) these risks?
- Do you have the right people in place, with relevant skills and the appropriate resources, to allow you to manage risk?
- Are your risk functions and senior risk officers sufficiently empowered to ensure that all key risks are brought to the attention of the board and not ignored?
- Are key individuals in the risk process sufficiently accountable for decisions that are made?




Financial and performance management is at the heart of the operating model. To use the analogy of a car dashboard, one lesson from the financial crisis is that the gauges and dials used to measure business performance may have been broken, or at the very least, may have not been showing a true and accurate picture. In some instances the measurements were being ignored – not through negligence but through a lack of confidence about their accuracy.

The financial crisis has exposed a failure in the ability of financial institutions to monitor their risk levels, to understand whether these are in line with their risk appetite, to understand whether they are making an adequate return and to ascertain whether they can survive a deterioration in market conditions. This, coupled with scarce capital, scarce liquidity and increased regulatory pressure, has led banks to re-evaluate the way they monitor their businesses.

Top quartile financial and performance management processes report relevant and meaningful metrics that are captured and reported both accurately and on time. Critically, they ensure that potential issues are identified and escalated rapidly for decision and action. But the challenges faced by those charged with ensuring that financial and performance measurement systems are best in class are significant. Key challenges include:

- Lack of agreement at senior levels regarding the critical metrics to measure;
- Ever more complex and ever changing accounting standards, such that investors and analysts are now faced with annual reports several hundred pages long that are hard to decipher;
- Changing requirements around capital and risk measures (driven initially by the introduction of Basel II);
- Significant demand for a focus on 'new' measures arising from the crisis (whether it be increased liquidity reporting or greater analysis of 'legacy' or 'distressed' asset positions); and
- A situation where data and processing weaknesses generate multiple 'versions of the truth', resulting in a lack of confidence in the underlying analysis on which to base decisions.

Performance management must therefore evolve to ensure clear visibility of the risks of the business and its underlying operational efficiency. Given increased scrutiny from the regulator and the need to meet the information requirements of shareholders, analysts and customers, the key consideration for leadership is how to fully embed financial and performance management within the business and operating models.

## Liquidity and capital management

The scarcity and high cost of capital and liquidity place the management of these fundamental resources high on leadership's agenda. In order to bolster liquidity certainty, many institutions are focused on the need for retail deposits and a reduction in their reliance on wholesale funding. But despite numerous statements of intent from regulators and governments, there remains no effective global framework to resolve the issues of liquidity and capital requirements. This is likely to result in new rules and regulations on capital at a local level that will make the delivery of good financial and performance indicators even more challenging.

Nonetheless, it is imperative that banks develop performance management models that:

- Drive capital and liquidity limits and utilisation well down into their business activities so that usage and inefficiencies can be monitored; and
- Ensure that, at a macro level, their corporate structures are effective from a capital and liquidity perspective.

## The pricing of risk

It is now very apparent that there was a serious dislocation of risk and return, and the sharing of risk and return, between stakeholders in the run up to the crisis. For example, losses at some institutions eradicated up to 10 years of accumulated profits, demonstrating that the provision of information to management on the returns being generated was not appropriate. The industry is beginning to respond to this dislocation and urgent redesign is already well under way in many institutions.

Financial and performance measures need to refocus on return for risk and ensure senior management receive accurate and globally sourced business portfolio analysis that is accepted by those running the portfolios. This analysis will need to:

- Align economic capital, regulatory capital and liquidity to these portfolios;
- Show the returns generated from these portfolios (both on a financial accounting and management accounting basis); and
- Facilitate deep cross-organisational reviews where returns are not acceptable, detailing the steps required to address any deficiencies.

As analysts scrutinise the underlying stability of the business, a critical consideration will be how to communicate the drivers of risk and RoE to the market. To date, many voluntary disclosures to investors and analysts (particularly those regarding portfolio positions in residential mortgage backed securities, commercial mortgage backed securities and leveraged finance segments) are an attempt to demonstrate levels of institutional risk and help investors understand where returns will be generated in future.

## Tighter cost control

Bank attitudes towards costs continue to evolve. The losers from the last 18 months have cut costs and investment to the bone with the attendant issues this generates. The winners have enjoyed a return to record revenues in the first half of 2009, arising from a flight to quality and wide spreads, which has eased cost pressures and allowed continued but careful investment in people, systems and processes.

The way in which banks analyse efficiency has changed, with evident emphasis on cost-income ratios and activity-based costing (where the unit cost of performing a certain activity is monitored and controlled). Banks should determine the level of granularity of costing that is appropriate to them, since it will vary depending on the particular nature of the business.

Additionally institutions need to reassess activities that are performed in lower-cost locations, to ascertain whether further cost advances can be achieved through more aggressive location strategies.

## Non-financial measures

Performance measures are far more than simple financial numbers. Senior management need a broad spectrum of indicators, to enable the operating model to be constantly refined and flexed as new challenges arise. Data on trades held in offline systems, operational risk losses, severity of control weaknesses, system performance and outages are just some of the critical measures required.

Of course, much of this already exists and is measured and reported; however, external scrutiny of it will increase and be more invasive. Banks must assess whether they are reporting the right non-financial measures, which are accurate and integrated with one another. Regulators will be far less amenable to inaccurate reporting and will also wish to see demonstrable action from management where trends are moving in the wrong direction.

## Planning for an uncertain future

Given the complexity and uncertainty in the market, in future banks need to manage the business against multiple scenarios rather than to a single strategy. The winners emerging from the crisis will be those banks managing against a suite of constantly evolving positive and negative scenarios reflecting the changing market and regulatory environment. Sophisticated financial and performance management systems and processes that can deliver against the required scenarios will require a long-term investment strategy.

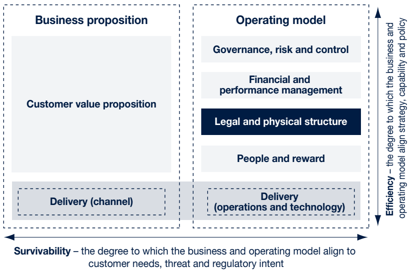
**Key questions for leadership:**

Have you assessed where your current financial and performance measures are appropriate, inappropriate, or simply missing?

- Do you manage the business to a defined set of constantly evolving scenarios (both positive and negative) which reflect your commercial and risk position relative to the changing market environment?
- Do your financial and performance management procedures provide you with an understanding of return on economic capital, highlighting where value is being created or destroyed?
- Given increased scrutiny by the regulator, how will the business balance both current and future risks against the imperative to make acceptable shareholder returns?
- Do your existing systems provide a clear view of the drivers of ROE and allow you to communicate them effectively to the market?

# LEGAL AND PHYSICAL STRUCTURE






New liquidity rules, capital requirements and other regulatory initiatives are changing the structure of banks' balance sheets and challenging fundamental business models. The complexities of banks' structures are also attracting attention from regulators. This, coupled with increased M&A activity among major industry players, points to a need to optimise the legal and physical components of bank operating models.

The regulatory environment is still evolving and uncertain. That uncertainty has increased since the announcement by the Obama administration of its wish to impose a 'Volcker Rule', preventing regulated deposit takers engaging in proprietary trading or making speculative investments in private equity and hedge fund assets.

A number of key observations, however, can be made, which will impact strategies and structures adopted by leading players in the market:

- Developing regulatory requirements will be the main driver of change. The eventual balance reached between global regulatory requirements and local regulatory initiatives will determine the extent of that change;
- The optimal location for a number of onshore and offshore banking functions and personnel is being called into question by a combination of politically inspired tax changes in some onshore jurisdictions, increased competition from other onshore jurisdictions and financial centres, as well as multilateral initiatives against tax havens and other harmful tax practices; and
- Existing portfolios of distressed and complex assets, including deferred tax assets attributable to the crisis, will influence the shape of change at particular institutions.

The key elements of the current landscape that impact legal and physical structures are as follows.

## 1) Higher capital, liquidity and leverage standards

Higher standards are being driven internationally through the Basel III process and will particularly impact structures where they are driven down to a granular level within individual legal entities and business lines. More granular standards will require:

- Stand-alone capital and liquidity strength for those entities and business lines; and
- Proper internal transfer pricing to prevent subsidy of risky activities.

## 2) Recovery and resolution plans – 'living wills'

From a structural perspective, the key aspect of 'living wills' proposals is to effect a degree of separation between systemically important and non-systemically important businesses. The objectives of these proposals are to facilitate:

- Either continued operation or an orderly rescue of systemically important operations; and
- An orderly resolution of non-systemically important operations, should the need arise.

'Living wills' proposals are designed to operate in tandem with revised insolvency regimes that allow for the separation of systemically important banking operations from the rest of a failing institution, such that they could continue as a going concern or be transferred to another institution while the rest of the institution is allowed to fail. To be effective, separation needs to ensure that systemically important businesses have stand-alone capacity to continue operating following institutional failure, with standalone capital, liquidity and funding, as well as insolvency-proof contractual arrangements, IT systems and secure access to personnel, etc.

The usual mechanism proposed to achieve these changes is to flex capital and liquidity controls. Institutions that restructure their activities to achieve greater separation of systemically and non-systemically important businesses would be rewarded with lower capital and liquidity requirements. In this way, the 'too big to fail' problem could in theory be reduced, with government and taxpayer subsidy and exposure to the banking system narrowed down to systemically important business.

**Living wills**

One of the FSA's main proposals for systemically important banks (discussed in its paper of 22 October 2009) is that they should be required to produce recovery and resolution plans ('living wills'), which set out how their operations would be recovered or resolved in an orderly fashion in the event of failure.

The beauty of the 'living will' proposal from the regulator's perspective is that it leaves open the possibility of achieving substantial reform of the banking sector after the credit crunch by side-stepping the probably insuperable obstacles to international agreement on a Glass-Steagall or Narrow Banking set of reforms.

In contrast to other such proposals, only a relatively limited number of issues need to be agreed internationally to render the proposals viable. After that, the details could, to a large degree, be worked out individually by regulators with particular banks, case by case. This has the merit of permitting regulation to be tailored to individual banks that, following the credit crunch, are increasingly pursuing a variety of different business strategies, which raises a variety of different issues for regulators. Nevertheless, this flexibility is also a weakness, making it harder to achieve a consistently level regulatory playing field, especially on an international basis.

How far living wills proposals are taken in practice remains to be seen – essentially, everything is still up for grabs. What is clear, at least, is that the living wills concept does have the possibility of significantly affecting the business models and operations of individual banks. The key issues banks will need to consider when approaching the subject and assessing its impact for them will be:

- How it will affect current regulatory capital and liquidity models, both between business lines and across borders, and what are the implications of such changes for individual operations;
- The possible need to separate functions within different legal entities or geographies and generally simplify group legal relationships;
- The impact on the structure of overseas operations and, in particular, the question of using subsidiaries rather than branches to satisfy the concerns of host country regulators;
- Tax, in relation to the direct costs of any reorganisation prompted by regulation;
- Tax, in relation to the strategic tax model for the business; and
- Operational changes including changes to systems and personnel, again to achieve stand-alone viability for particular operations.

Source: PricewaterhouseCoopers Banking Bulletin, October 2009

## 3) Physical separation – Obama administration 'Volcker Rule' and similar proposals

Until the Obama proposals were announced in January, the idea of physical separation appeared to have gained little traction with regulators for several reasons:

- A perception that modern banking operations are too integrated to permit easy separation;
- A view that separation is undesirable and impractical given the nature of client demands on the financial services industry; and
- Concerns that separation is too simplistic a response to systemic risk given that the crisis required taxpayer bail-outs across the full spectrum of universal banks, narrow banks and 'shadow banking' players.

The Obama proposals have obviously changed all this. It remains to be seen, however, how the initial proposals will be put into practice in the US, and whether other significant jurisdictions will follow suit. The situation is extremely unclear and there is a real possibility that the eventual outcome is a regulatory framework for banks that differs significantly between different jurisdictions.

## Moving forward in an uncertain world

With Western governments under unprecedented fiscal pressure and electorates facing higher taxes and cuts in services, the current political and popular pressure on the banks is unlikely to abate soon. Continuing unease at the concentration of the banking sector, following the crisis and doubts about the efficacy of other regulatory proposals, ultimately add to the pressure on the sector. Set against these pressures are the need for governments to deliver value for taxpayers where they hold stakes in particular banks or financial sectors, as well as the desire to see a revival of lending into the wider economy and concerns about possible overregulation.

How these conflicting pressures ultimately play out remains unknown, but the main challenges to bank structures, and the planning issues they give rise to, can already be seen.

## Accounting for the cost of capital

In the wake of the crisis and in advance of new regulation, some banks have already been assessing the merits of central funding and capital models where utility deposit-taking activities support riskier activities. The alternatives considered include transferring the costs of capital, liquidity and funding to individual business lines. These transfers would take place either through more accurate cost allocation within the existing single legal entity, or by business lines into separate legal entities. The most obvious outcome of such a transfer is that risky banking activities will be reduced. Safer retail banking activities, meanwhile, will receive a higher return for providing funding to (and possibly holding liquid assets for) risky investment banking operations.

The Basel III capital and liquidity agenda is the most advanced and certain part of the regulatory reform process. As that agenda pushes at a granular level into bank entities and business lines, cost benefit-analysis will be necessary to determine whether certain operations and legal structures will continue to be sustainable, given increased capital and liquidity requirements. If risk is to be measured differently for different banking activities, management will also need to consider how best to allocate the costs of capital, liquidity and funding between business units when undertaking cost-benefit analysis.

Changes in the way risk is measured and in the allocation of capital, liquidity and funding costs may produce a significant shift from the historic model, in which banks have often allocated funding between business lines (especially within the same legal entity), using an average cost of funds model and allocated capital based on risk-weighted assets, with no formal allocation for liquidity costs.

## Tax to follow regulatory lead

The advent of tougher regulatory transfer pricing will lead naturally into the tax transfer pricing of banking groups with cross-border operations. Previously, the attention paid by tax authorities to the location of capital has been variable; and the attention paid to liquidity pricing has been generally low to non-existent. Regulatory changes in this area will make it very difficult, if not impossible, for tax authorities not to follow the regulatory lead.

Traditional regulatory capital and tax planning has tended to favour relatively simple structures, with limited numbers of legal entities acting through overseas branches to permit the most efficient use of regulatory capital, both commercially and for tax. If implemented, proposals to trap pools of local capital, funding and liquidity around systemically important businesses or entities – whether under ‘living wills’-style proposals or initiatives to subsidiarise local operations – will tend to cut across much traditional regulatory capital and tax planning. Future planning in both areas will need to cater for more onerous regulatory requirements.

## Individually tailored solutions

How far 'living wills'-style proposals are taken towards requiring effective separation of systemically and non-systemically important businesses within banks remains to be seen. It is possible that the FSA's proposals may require banks to prepare for other parts of 'too big to fail' institutions to be sold off as going concerns during or following failure. The eventual outcome will depend, among other things, on the findings from the FSA's living wills pilot programme in the UK, the international response, the impact assessment being carried out by the Basel Committee, and the political appetite of individual governments to force structural change.

Depending on the outcome, bank management will need to consider how far restructuring around the 'living wills' regulatory agenda may benefit the bank in terms of potentially reduced regulatory capital and liquidity costs. A particular feature of living wills proposals is the degree to which the regulation is tailored to the institution, rather than regulatory standards being set centrally and the market then being allowed to set by reference to them. A more customised solution hands a greater degree of planning initiative to management.

Until further detail is given it is more difficult for banks to assess their planning options with respect to the Obama proposals, but one possibility is that institutions may be able to adapt by reorganising into regulated and unregulated chains of businesses.

## Costs without benefits?

Many of the current proposals may prove to be impractical to implement and could significantly impact the sustainability of certain banking models. There is also a risk that increased regulatory costs may not be supported or justified through appropriate analysis and may ignore, or underplay, important factors such as governance and operational procedures, as well as the benefits of diversification.

As a result, the proposals may not be successful in significantly reducing systemic risk, but could come at a significant cost to the global economy, by increasing compliance costs for banks and in some cases making it unviable for banks to offer complete global banking services to their large multinational clients.

A further concern is that the regulatory framework may differ significantly in different jurisdictions, distorting competition and creating regulatory arbitrage. This is a particular concern with living wills-style proposals, which are individually tailored to a bank's operations and structures. The end result could be that banks may no longer be competing on a level playing field, distorting competition between banks individually and between different financial centres. The announcement of the Obama proposals raises further concerns that, in future, there may be significant differences in the regulatory framework in different jurisdictions.

Ultimately, if the regulatory cost of undertaking certain activities proves to be too high, activities perceived as high risk may shift from large regulated institutions to smaller and possibly less regulated boutiques.

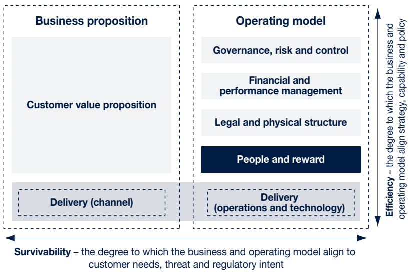
**Key questions for leadership:**

Does your legal and physical structure position you in an optimal way to take full advantage of new market opportunities, while preparing you for possible regulatory interventions that will fundamentally change the way you operate?

- What is the geographical footprint that will be required to service new market opportunities, tap into new sources of capital and optimise your tax position?
- What steps have you taken to address the possible regulatory requirement to separate investment banking and retail banking operations, including legal entity challenges and living will proposals?
- How will you optimise value to the business while balancing your response to regulatory interventions around complex legal, liquidity and booking arrangements?

# PEOPLE AND REWARD






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

There are a number of key areas that will require firms' attention over the short- and medium-term. These include the need for appropriate risk-adjusted measurement systems and, where appropriate, for these to be cascaded further down into the business, ideally to business unit level. There also needs to be a more balanced set of measures. The level of deferral needs to be reviewed, as does the possibility of determination of deferred compensation, to be brought closer to the value of the business that generated the bonus in the first place, while striking a balance between individual accountability and a partnership ethos. It is equally important that appropriate qualitative risk-based oversight of bonus pool determination is established. The role of discretionary judgement about quality of earnings, linking information about risk with information about compensation, is vital.

'The remit of the remuneration committee should be extended where necessary to cover all aspects of remuneration policy on a firm-wide basis with particular emphasis on the risk dimension.'

The Walker Review, A review of corporate governance in UK banks and other financial industry entities, 16 July 2009

People and reward policies must be realigned to ensure long-term sustainable success for the business, while attracting an appropriate level of talent. Banks should consider a number of key principles when assessing reward policies:

- Incentivise cross-functional working and discourage operational silos;
- Break down divisions between front, middle and back office by rebalancing reward so that cross-business collaboration is encouraged;
- Design remuneration policies to avoid incentives for undue risk-taking by integrating risk management considerations into remuneration decisions; and
- Ensure greater transparency and control is achieved to scrutinise company-wide pay schemes – a key theme in the Walker Review.

'A significant element of trading book profits recorded in the years running up to the crisis proved in retrospect illusory. These illusory profits were however used as the basis for bonus decisions, and created incentives for traders and management to take further risk'

The Turner Review: A regulatory response to the global banking crisis, March 2009

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

In future, banks need to ensure that they recruit and retain the right people to meet the changing requirements of the industry and the market. While there are challenges in the near term, it is vital that banks look beyond their short-term issues and think strategically about the skills mix required to succeed in the new market reality.

**Key questions for leadership:**

What are the core values of your brand, how embedded are these across your organisation and how will you win over the hearts and minds of your people to deliver them?

- What are the skills that will be required to drive your vision, manage your risk and differentiate your business in the marketplace?
- How will you regulate risk and reward while encouraging cross-functional collaboration?

# Moving forward

One of the most consistent themes that we are seeing across the banking industry is the need to work cross-functionally and eliminate the silo culture and approach to processing that has developed both from a product perspective as well as across the support functions. This appears to have been exacerbated as a result of the move to a dispersed global model involving near-shore, offshore and outsourced functions.

Banks need to look across these boundaries to survive and be efficient. Current practices result in duplicated effort and a lack of transparency around roles and responsibilities. In order to break down these silos, leadership needs to drive a clear commitment to cross-functional working.

There are significant challenges in joining up business processes, including, but not limited to, culture, technology, governance and reward (i.e. incentives to work cross-functionally). Nevertheless, the banks that get it right will drive significant competitive advantage through a more agile and robust platform on which to operate.

**Cross-functional 'hand-offs' in investment banking**

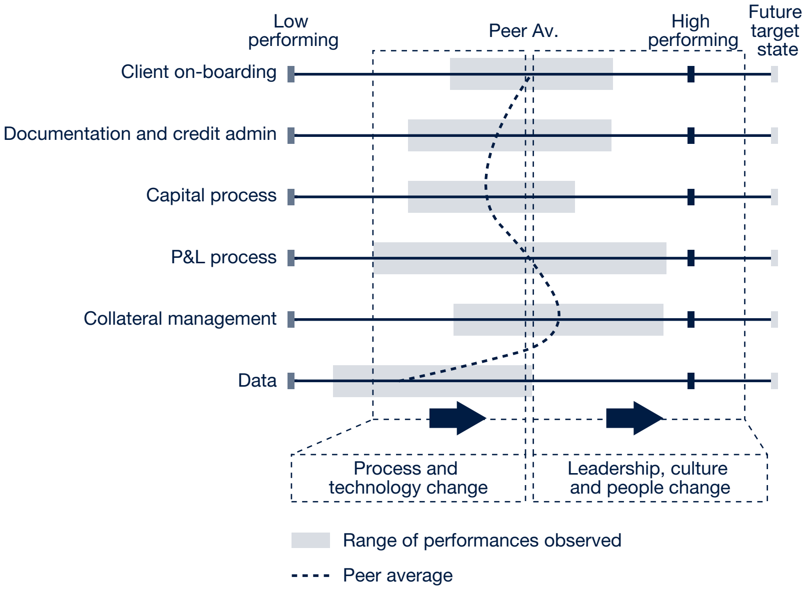
A key challenge for banks concerns how they remove operational silos and promote cross-functional working. Cross-functional 'hand-offs' between different departments often result in inefficiencies, delays or errors across business processes.

PricewaterhouseCoopers conducted research into the relative performance of a selection of investment banks across a range of key process hand-offs and mapped the range of performance observed (this is shown in the following diagram).

The research indicated that moving from low to average operating performance can mainly be achieved through improving processes, technology and the way people are deployed; however, building a world-class operating model requires leadership, the right cross-functional culture and highly skilled people.

What was also clear from the analysis was that there is significant room for improvement across the industry, and even top performers are a long way from achieving a target future state of seamless cross-functional cooperation.

**Analysis of selection of cross-functional 'hand-offs' in investment banking**




Source: PricewaterhouseCoopers analysis, 2009

Wholesale change of bank operating models, in their fullest sense, is required to ensure that banks are protected from future shocks and are able to take full advantage of new market opportunities.

In this paper we have simplified and broken out the component parts of the operating model, providing key observations and questions that leadership need to consider in the context of their organisation. The reality is that all of these factors need to be worked through together and combined in a coordinated cross-functional manner. Getting this right is highly complex, and will involve careful prioritisation of investment to drive structural change in the underlying efficiency of operating models.

In our experience there are a number of common reasons for transformational failure, which must be avoided:

- **Lack of a common leadership vision:** Failure by leadership to agree and communicate a clear vision will result in poor cross-functional communication, middle management resistance and challenge from the business during implementation;
- **Poor understanding of the desired end state:** Frequently the drive to achieve early 'wins' results in a rapid dive into detail, which in turn causes a failure to understand higher order opportunities. This means that resource and investment capacity is quickly absorbed and transformational change is missed;
- **Failure to deconstruct the business problem into component parts:** Thinking within a current model, process or organisational structure can restrict the identification of opportunities for change; and
- **Silos operating in isolation:** Transformation will impact multiple functions and driving change in isolation results in challenge and resistance. Furthermore, good practice within the organisation should be leveraged across functions.

Winning banks will be those that 'relish change' with an unrelenting focus on achieving a sustainable and flexible operating model that is fully entwined with the business. A key point is that moving from low to average operating performance can mainly be achieved through improving processes, technology and the way people are deployed; however, building a world-class operating model requires leadership, the right cross-functional culture and highly skilled people. There are five imperatives that winning banks will in future demonstrate in their operating models:

### 1) A consistent cross-functional approach embedded within the organisational culture

Governance of core cross-functional processes requires well-defined accountability alongside clear guidance on roles and responsibilities. Leading banks recognise the importance of developing people's technical competence, but more importantly of providing them with an understanding of how they fit within the wider organisation and how they contribute to its overall success.

When embedded in the organisation's culture this provides a common goal where people naturally work cross-functionally to overcome process or technology deficiencies. Furthermore, there is recognition that processes and technology are inherently inflexible and it is the people that provide the required adaptability to external events and changing customer demands.

### 2) Clear leadership in the identification and communication of the business vision

Organisations that have been successful in tackling cross-functional issues and operating model problems have a well-communicated vision (target state) and a clearly articulated benefits case. Strong leadership from the top of the organisation is critical in ensuring that the vision is not diluted and is consistently adhered to, despite often requiring multi-year investment to reach the target state.

### 3) Performance management embedded at the 'heart of the business'

Leading banks are gaining market advantage through their ability to gather quality information (rather than just data) that enables better decision-making and faster responses to customer demands. Leading banks have invested in technology to enable efficient data gathering and analysis.

### 4) A common source of data on which to base decisions

Getting data right, first time, at the point of entry is a challenge for all banks, but leading banks are investing significant resources in this area to continuously improve the quality and timeliness of data as well as move towards 'golden' sources. A focus on common data is a fundamental enabler of a bank's ability to respond to shock events.

### 5) A culture of continuous improvement

Leading banks use the information from a process failure to seek out better ways of working, rather than creating a process to fix the same problem multiple times. High-performing organisations have a relentless focus on standardising and automating processes, with a focus on understanding exceptions and managing them as efficiently as possible through workflow.

This will not be the last crisis and those banks that optimise their operating models for the new market reality will not only drive competitive advantage, but will also ensure their future survival. Leadership need to ensure that they have the right teams in place and engage with the right advisers to help them resolve these issues and drive meaningful change throughout the organisation.

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