



FINANCIAL SERVICES

Beyond Turbulent Times: Transforming Banking Business Models

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ADVISORY





Over 50 percent of financial services executives see the economic recovery beginning in 2010 and are preparing for the future. Companies are beginning to emerge from one of the most difficult economic environments since the great depression, an environment that has created dramatic changes to the financial landscape. While the outlook remains challenging for financial services companies, there is increased emphasis on transforming business models to align with evolving strategies and capitalize on opportunities, attain profitable and sustainable growth, and manage the cost structure.

Both Wall Street and Main Street have experienced considerable turbulence over the past two years, and many challenges remain. Yet over the past few months, a number of leading economic indicators have been on the rise, pointing to stabilization of the economy and generating hopes that a recovery is already in motion. Although the credit crisis and resultant financial turmoil clearly hit the banking and finance sector hard, a recent KPMG business climate survey¹ of banking and finance executives reveals optimism in this industry. A large majority of respondents believe that the industry will see improved business conditions, and greater quarterly revenue and profitability, one year from now. Fifty-one percent of these executives see a substantial U.S. economic recovery by the end of 2010, with another 29 percent believing such recovery will be achieved in 2011.

Despite the continued uncertain outlooks for the real estate market and unemployment—each of which takes a toll on consumer and business confidence—many are beginning to look to the future. Companies are beginning to emerge from one of the most difficult economic environments since the great depression, an environment that has created dramatic changes to the financial landscape. While the outlook remains challenging for financial services companies, there is increased emphasis on transforming business models to align with evolving strategies and capitalize on opportunities, attain profitable and sustainable growth, and manage the cost structure. Such transformation may well be all-encompassing: companies are searching for new products, services, or other income generators to drive top-line growth, while still managing costs efficiently and without compromising risk management principles.

¹ KPMG LLP, *Financial Services Executive Survey Points to Economic Recovery*, 2009.

Examining Revenue Streams

The KPMG business climate survey highlights the importance of identifying incremental revenue streams in the face of increasing regulatory scrutiny over the way banks charge and assess fees to their consumer client base. In responding to a question on significant challenges resulting from the economic downturn, 57 percent of executives cite the need to find new sources of revenue growth. This is even more critical due to the recent banking business model where many basic consumer products have been offered free of charge (across DDA, credit card, and supporting channel access), with yield spreads, fees, penalties, and—more recently—credit and securitization innovations generating the revenue.

Today, banks are facing considerably greater regulatory scrutiny surrounding fair lending practices, unfair or deceptive acts and practices, and revenue generation from fees and penalties. Yield spreads are now minimal, and the securitization market is a fraction of its former self. In this environment, the subsidized approach no longer appears viable.

Moving forward, we see two strategic models that companies may pursue.

The Traditionalist Model

In this model, the bank follows a “back-to-basics” approach to serve its consumer and commercial clients, with emphasis on traditional commercial banking products including checking and savings accounts, credit cards, mortgages, and standard investment vehicles. When offering what many would consider to be commodities, banks adhering to this model will likely need to strive to become economically advantaged relative to their peers in order to grow profitably. All this must be accomplished while providing competitive products and customer service.

The Innovative Model

While not completely disregarding the need for cost optimization, other banks are focusing on truly new and innovative products or services that add value for the customer. The goal is to garner not only incremental market share but also offer high enough customer value to generate additional banking fees. The innovative model could involve incremental charges for such optional services as high-speed transfers or notification of transactions being delivered to a mobile device through text or e-mail alert. A service that is gaining popularity in many parts of the world is that of mobile payment options. Enhanced information protection is another service that may be considered worthwhile as identity theft continues to spread.

Other areas of focus may examine how to create products that have all the feature and functionality of transaction accounts, credit and debit cards, and investment vehicles products rolled up into a single account that can be priced commensurate with the value it would create for the consumer client. A potential single account cash management vehicle may solve many of the intentions of current banking regulation under discussion. Although U.S. banking regulations present several

obstacles that impede the expansion of these types of innovative product offerings, industry and regulatory dialogue may be able to facilitate innovative product expansion that will support the intent of current and future regulation. It is becoming apparent that future innovation must create products and services that offer the features and functionality that customers are looking for, with the price transparency required for consumers to make educated decisions on how to manage their banking relationships, while allowing banks to pursue a viable business strategy.

Many European banks, due to the Financial Services Authority pushing Treating Customers Fairly (see sidebar), have already learned lessons that could be applicable to the U.S. banking market with respect to product innovation that provides value and fulfills the spirit of consumer protection.

Whether the concentration is on more basic consumer products and services or leading-edge innovations, the challenge is to transform the business model from one where consumers expect to be subsidized to one where the customer recognizes that banks are providing value worthy of a certain pricing level.

Treating Customers Fairly: Aligning Consumer Protection and Customer Service

In 2006, the United Kingdom's Financial Services Authority introduced Treating Customers Fairly (TCF)², a regulatory initiative using a principles-based approach to help ensure the fair treatment of retail customers. In light of the events of the past two years, TCF has in many respects taken on added significance.

TCF looks to achieve the following outcomes:

1. Consumers can be confident that they are dealing with firms where the fair treatment of customers is central to the corporate culture.
2. Products and services marketed and sold in the retail market are designed to meet the needs of identified consumers groups and are targeted accordingly.
3. Consumers are provided with clear information and are kept appropriately informed before, during, and after the point of sale.
4. Where consumers receive advice, the advice is suitable and takes account of their circumstances.
5. Consumers are provided with products that perform as firms have led them to expect, and the associated service is both of an acceptable standard and as they have been led to expect.
6. Consumers do not face unreasonable postsale barriers imposed by firms to change product, switch provider, submit a claim, or make a complaint.

Ultimately, TCF strives to embed these principles into a financial institution's corporate strategy, culture, and day-to-day operations. As such, the expectation is to address the fair treatment of customers throughout the product life cycle, including product design, target marketing, sales, and advice.

Those banks that have embraced TCF principles may be farther along the evolutionary path of a business model where products and services that offer true value to customers are available at an appropriate price, considering appropriate risk characteristics.



Banks will need to make strategic decisions regarding which revenue streams will have the most potential, considering their existing customer base, appetite for risk, and capital position. Those banks that most carefully articulate the desired end state will be more likely to achieve competitive advantage. But transforming the banking business model will require investments of both time and money. From changing technology to retraining staff to implementing pilot programs, the cost side of the business model equation cannot be ignored.

The Industry Continues to Examine Its Cost Structure

The survival mode of many companies in the recent past necessitated immediate and drastic cost cutting measures, of which the easiest to effect was often reduction of personnel. However, there is a balance between cutting costs and maintaining an expected level of customer service and appropriate risk management. In another sign of optimism for the future, only 15 percent of respondents in KPMG's business climate survey indicate plans for further headcount reductions while only 16 percent plan to cut investment in research and development. While significant human resources cost reductions now appear to be in the past, opportunity still exists in many pockets of indirect expenditures by viewing cost optimization through a strategic, rather than a siloed, lens. There further appears to be vast opportunity for cost optimization as banks examine their current business processes and vendor relationships, and create their roadmaps for executing strategies.

A strong majority of survey respondents, 59 percent, emphasize strategic investment for long-term growth as opposed to cost cutting for survival. Such strategic investment for long-term growth and competitive advantage is at the heart of realizing an optimized cost structure. And this begins with understanding how a company's overall business model impacts costs. As the banking business model undergoes transformation in order to realize new growth opportunities, it will be important to understand both the short-term "shocks" to costs while implementing new processes, technology, or compensation structures as well as the long-term cost implications. Especially as capital adequacy remains a consideration, optimization entails balancing short-term expenditures with long-term investment, quarterly objectives with forward-looking goals.

However, cost optimization is a significant piece of the profitable growth equation even when there are no plans for significant changes to revenue streams. A holistic approach to cost can break down the silos among operational functions, searching for synergies and efficiencies. It allows for insights into potential benefits or unintended consequences stemming from cost-sensitive decisions. In this light, savings from cost reductions in one area may fuel the investment needed in another area.

One transformational cost opportunity that most of the largest U.S. banks are examining, or in the process of implementing, is the long-discussed Branch Image Capture solution for servicing retail and commercial clients. Such strategic



solutions have several variations (front counter, back counter, hybrid) but all focus on alternatives of digitizing customer transaction information at the point of presentment (i.e., at the branch). This allows for expedited processing, creating revenue opportunities that can be shared with clients and significant cost reduction opportunities across transportation and check processing support areas. These strategies involve significant up-front commitment from the banks but have shown transformational cost enhancements on the back end.

Two functions with direct bearing on cost also deserve special mention.

Procurement/Strategic Sourcing

The procurement function is an area that in the past has received little attention, with a reputation for processing or order-taking rather than providing true value. However, this function has the potential to promote efficiencies and also to drive innovation and process improvements. Untapping potential by looking at costs strategically will open doors to cost benefits. Management may want to consider:

- Is the procurement area functioning consistent with company guidelines?
- Does procurement promote the desired spending culture?
- Is senior management supportive of the culture and processes?
- Are policies and procedures appropriate for commodity purchases versus service purchases?
- Are controls in place to help manage the many risks?

The center-led “hub-and-spoke” model of procurement is gaining in popularity due to its mix of centralized strategic sourcing—allowing for one consistent approach to forecasting, planning, and cost management—combined with individual business units executing on such plans.

Vendor Management

Vendors have become integral to financial institution operations, affecting the ability to respond to the end customer. The consequences of poor vendor performance can impact not only direct costs but also a bank’s reputation in the eyes of the customer. As such, there is increasing importance placed on vendor management, a process that should include specific goals and measurable metrics surrounding such items as cost, productivity, quality, and timeliness. Periodic, regular monitoring of such metrics provides the information necessary to determine if specific vendor relationships are providing optimized value for the services gained.

Regardless of the function, successful cost structures include a process that sets cost management objectives, identification, and execution on both areas where sustainable savings can be achieved and where investment is needed, and monitoring of progress against strategic objectives.

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Conclusion

With optimism that global economies are beginning to emerge from an especially challenging landscape, there is increased recognition that the landscape has changed. Heightened regulatory scrutiny—with increased compliance requirements—already exists, while consumers and businesses are adapting to a more risk-averse environment. In this new world, banks are also adapting, searching for new strategies that allow for profitable growth.

The transformation of existing business models will take many forms—as many forms as there are individual banks with individual risk appetites and risk profiles. Those companies that are successful will be balancing many moving parts, with opportunities available on both sides of the revenue-cost equation. That equation does not imply simply raising revenue or cutting costs. Rather, transformation will involve fundamental changes to the business model, determining where to invest for revenue growth, and determining how best to improve efficiencies.

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