

strategy&

*The future
of banking*

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**Reappraising core
capabilities after
the crisis**



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Originally published by Booz & Company as “The Future of Banking: Reappraising Core Capabilities after the Crisis,” by Vanessa Wallace and Andrew Herrick, in 2009.

Executive summary



For all the chaos in the global banking sector since mid-2007, some things have not changed. The purpose of banking, the needs of customers, and the core capabilities that drive the strategies of the most successful banks have endured.

What has changed is the environment in which banks operate and compete. The level of government regulation and ownership in the sector has risen dramatically. The banking value chain has been fractured, particularly the links between banks and their customers, in pursuit of returns that proved unsustainable and must now be reforged. Finally, the outlook has shifted to what will almost certainly be a prolonged period of low growth in the broader economy and the banking sector itself, with important implications for how banks compete and capture value.

If banks hope to survive and prosper, their leaders can neither conduct business as usual nor adopt temporary fixes and half-measures. They must respond at a more fundamental level, bolstering — and, to the extent that they are not already in place, creating — the essential organizational capabilities for the post-crisis era. This report is designed to guide bank leaders as they ready their institutions for the challenges and opportunities ahead.

The future of banking

The global financial crisis has triggered dramatic alterations to the global economy and the financial-services landscape. The banking industry has been accused of bringing the world to its knees by taking breathtaking risks, spurred by astronomical compensation, with little regard for the consequences. Much energy has been expended in debating the responsibility for this upheaval; however, banking leaders cannot afford to engage in the blame game. They must realize that despite the chaos and restructuring experienced by the banking sector, the fundamentals of banking are unchanged. They must continue to fulfill the societal purpose of their institutions while steering them to safe harbor and future success.

To achieve this, senior leaders must recognize three developments that have been set in motion by the financial crisis:

- The role of government is growing around the world, as witnessed by increased regulation and even outright ownership of the sector.
- There is now an urgent need for banks to reintegrate the value chain and regain their traditional closeness to the customer in order to better manage risk and create value.
- The outlook has shifted to what will almost certainly be a prolonged period of low growth, with important implications for how banks compete and capture value.

Although the fundamentals of banking are unchanged, banking leaders cannot respond to these challenges with the kinds of short-term solutions and temporary fixes that are used to weather minor cyclical dips. Instead, they must analyze and adjust their companies' core capabilities in their continuing quest to outperform the market and their competitors.

Mapping the new banking landscape

Three of the four largest retail banks are now Chinese state-owned enterprises. Six of the largest 20 banks are new to the top of the order. Nine are now based in the broader Asia region, including HSBC, which has announced that group chief executive Michael Geoghegan will move from London to Hong Kong, and two banks from the much smaller nation of Australia (*see Exhibit 1, next page*). The stand-alone investment bank, which formerly dominated much of the sector, has all but disappeared. Consolidation is creating high levels of concentration in the banking industry; witness J.P. Morgan's takeover of Washington Mutual in the U.S., the merger of Lloyds TSB and HBOS PLC in the U.K., and Westpac's purchase of St. George Bank in Australia. The ranks of the truly global retail banks are thinning, as yesterday's titans retreat to the security of their home markets and capital bases, while domestic banks are merging, disappearing, and narrowing the focus of their businesses.

It is not just the footprint of the industry that has changed; its business models and supporting structure are being altered too. The value propositions of seemingly timeless models in securitization, mortgage brokerage and insurance, private banking, and even financial advice are being questioned. The independence and relevance of the institutions that support confidence in the entire sector — rating agencies, credit bureaus, and regulators — have been compromised. Sovereign risk has become a component of bank risk registers, since many counterparties are now functioning only with the support of their home governments. And perhaps most critical, the public trust on which banks and bankers depend has eroded — a trend that has been exacerbated recently as some of the banks that received U.S. and U.K. public bailout money have gone on to reap record profits, and in some cases have even returned to the practice of paying massive bonuses to staff. Besides the visible populist reaction in many countries, there is also a quieter, but perhaps more serious erosion in the credibility of the banking profession, particularly among long-term investors, pension fund and endowment managers, and large depositors.

Exhibit 1

A reordering of the world's leading banks, 2007–09

Top 20 (February 2007)

Rank	Company		Market cap (US\$B)
1	Citigroup	U.S.	247
2	Bank of America	U.S.	227
3	ICBC	China	205
4	HSBC	U.K.	202
5	JPMorgan Chase	U.S.	171
6	Bank of China	China	146
7	Mitsubishi UFJ	Japan	133
8	China Construction Bank	China	127
9	UBS	Switzerland	125
10	Royal Bank of Scotland	U.K.	124
11	Wells Fargo	U.S.	117
12	Banco Santander	Spain	116
13	BNP Paribas	France	97
14	Unicredit	Italy	97
15	Barclays	U.K.	95
16	ING	Netherlands	94
17	Intesa Sanpaolo	Italy	93
18	Goldman Sachs	U.S.	91
19	BBV Argentario	Spain	87
20	Credit Suisse	Switzerland	84

Top 20 (July 2009)

Rank	Company		Market cap (US\$B)
1	ICBC	China	259
2	China Construction Bank	China	190
3	HSBC	U.K./HK	175
4	Bank of China	China	160
5	JPMorgan Chase	U.S.	152
6	Bank of America	U.S.	128
7	Banco Santander	Spain	118
8	Wells Fargo	U.S.	114
9	Goldman Sachs	U.S.	84
10	BNP Paribas	France	78
11	Bank of Communications	China	71
12	Mitsubishi UFJ	Japan	70
13	Itau Unibanco	Brazil	67
14	Royal Bank of Canada	Canada	67
15	BBV Argentario	Spain	61
16	Credit Suisse	Switzerland	56
17	Barclays	U.K.	56
18	CBA	Australia	54
19	China Merchants Bank	China	53
20	Westpac	Australia	53

Fallen from Top 20 since 2007

New to Top 20 since 2007

Source: Datastream

The fundamentals of banking are unchanged

Despite all of this chaos and restructuring, the primary purpose of banking remains unchanged. Banks have always performed a critical set of functions in support of society and human endeavor. They provide a safe haven for the savings of individuals and businesses; they allocate capital across the economy efficiently and effectively; and they bridge the divergent maturity needs of short-term depositors and long-term borrowers. If the global financial crisis has demonstrated anything, it is the continuing and essential nature of these banking functions to society.

The functions of a bank reflect the needs of its customers, and these, too, remain unchanged. Banks provide accounts and services that enable individuals and organizations to safely hold cash and make transactions. They provide loans that enable customers to bring forward expenditures or investments that would otherwise require years or decades of saving. They help protect customers by absorbing risks that otherwise could not be borne at either an individual or organizational level. They provide savings vehicles that enable customers to invest their money. And they assess their customers' financial needs and advise them as to the products and services that best match their financial objectives.

Finally, the core organizational capabilities that banks need to pursue their purpose and meet customers' needs have not changed. These are customer management, product and offer development, risk management and pricing, distribution management, operations and IT, asset and liability management, capital management and portfolio strategy, talent management, investor relations and stakeholder management, and performance management.

So, if the fundamental nature of banking — its purpose, the needs of its customers, and the core capabilities it requires — remains unchanged, how will the future of banking be affected by the current financial crisis?

As noted above, some overarching developments have been set in motion by recent events. They represent three broad areas where financial-services institutions will need to change their practices and ways of thinking.

The utility-like regulation of banking

The magnitude of the government response to the financial crisis will have fundamental and long-lasting effects on banks everywhere. In the short term, governments have been (and continue to be) forced to bail out insolvent institutions, supplying liquidity and guaranteeing obligations so these banks can survive — and, in some cases, taking ownership stakes in exchange. In the medium to long term, Western governments will seek to exit these investments in an orderly manner. However, a much broader debate with more enduring consequences is occurring around the long-term regulatory framework for the banking sector.

It is highly likely that in the aftermath of the financial crisis, the regulatory landscape in banking will more closely resemble that of utilities, such as electric, gas, telephone, and water companies, that provide society with a “public good”: a product or service that is considered so essential that its delivery cannot be left to market forces alone. Utilities tend to face a high regulatory burden, which dictates many elements of their pricing, customer bases, and competitive environment, and which therefore often inhibits their levels of innovation and experimentation.

In many countries, the regulatory pendulum in banking had swung toward free markets during the previous 30 years. Many banks were partially or completely privatized in the quest for greater efficiency, enhanced ability to attract and retain management talent, and greater access to global capital to fund innovation and growth. But now, five driving forces are causing the pendulum to swing back:

- **The growing perception that banking is a public good:** Recent events have reinforced the fundamental truth that a steady flow of credit and a stable banking sector are as important to a productive economy as abundant resources, physical infrastructure, and human capital.
- **The understanding that markets are not always efficient:** For decades the prevailing logic has been that market forces can best connect the sources and users of capital — with the resulting price

accurately reflecting all available information and therefore being, by definition, “right.” While the free market philosophy is clearly here to stay, there is a growing realization that people, and markets, can and do behave irrationally, and that these “animal spirits,” as John Maynard Keynes famously called them, can dramatically skew market behavior.

- **The rising levels of systemic risk:** The increasing interconnectedness of the global financial economy has introduced multiple, and often hidden, points of failure. Strategies that make sense at the level of a business unit or a single institution (for example, regarding portfolio choices, product offerings, or capital allocation) may not optimize outcomes at the level of a large bank, a national economy, or a global financial system.
- **The realization that “too big to fail” is simply too big:** The consequences of failure among key banking players are causing policymakers to reappraise the need for governmental control over the size and scope of the largest banks.
- **The broader consequences of misaligned compensation and risk management structures:** Existing compensation models, in both the size and the design of their incentives, encouraged outsized risks by bank employees. They enjoyed the upside reward, but left shareholders, and ultimately governments, responsible for the downside. The extent and speed with which these drivers will affect banking regulation depend on a range of factors, including the strength of each nation’s banking system, the broader economic outlook, and the market philosophy that holds sway with the government. But the overall rise in state ownership and regulation has implications for banks’ portfolio choices, product offering and pricing, investment and capital management, and reporting and talent management (*see Exhibit 2, next page*). Further, if banks do not or cannot fulfill their larger societal purpose, governments will stay involved longer and enact stricter regulations, which could result in a less global, less innovative, and less talented financial sector.

Exhibit 2

Implications of government ownership and utility-like regulation

	Short-term government ownership	Longer-term utility regulation
Portfolio choices	<ul style="list-style-type: none">– Restricted global aspirations, as governments draw in capital and restrict activities to national boundaries– In countries where multiple players have been acquired, potential breakup with merger of similar lines of business to create single-purpose utilities	<ul style="list-style-type: none">– Likely return of Glass-Steagall-style separation of retail banking, investment banking, insurance, and wealth businesses– Closer monitoring of mergers — potentially similar to Australia’s “Four Pillars” policy — to maintain competition and avoid “too big to fail” scenario
Product offering and pricing	<ul style="list-style-type: none">– Potential for government to provide basic services — simple, low-cost banking, savings and pension accumulation, basic protection– Increased requirements on loan portfolio, including pricing of risks and flow of credit to specific sectors	<ul style="list-style-type: none">– Supply-side regulation around pricing and customer choice for “critical” products — low-cost transaction banking, access to basic credit, retirement savings and pensions, life insurance, health savings accounts
Investment and capital management	<ul style="list-style-type: none">– Free cash flows siphoned off in the form of dividends to the government, constraining investment options and potentially stifling innovation	<ul style="list-style-type: none">– Much greater intervention across the board to ensure “protection” of community — e.g., funding and liquidity regulations– More sophisticated calculation of minimum capital requirements — e.g., linked to economic cycle, bank risk processes and appetite, compensation models
Reporting	<ul style="list-style-type: none">– Greater focus on forensic reporting into areas of interest to governments — e.g., economic stability and political agenda	<ul style="list-style-type: none">– More comprehensive and onerous reporting requirements– Need for reporting to satisfy broader set of stakeholders, provide greater transparency, and cover longer-term perspectives
Talent management	<ul style="list-style-type: none">– War for talent between private and public sectors, similar to the competition between healthcare and education sectors in most developed economies	<ul style="list-style-type: none">– Shift to long-term compensation models to limit short-term risk taking

Source: Strategy&

Banks reassert ownership of their assets

Many of the excesses that contributed to the financial crisis are related to the unbundling of the banking value chain and the resulting decoupling of assets from risks. Banks shifted from a long-term, balance sheet management approach focused on maximizing return on assets to a short-term, earnings-driven approach that maximized return on capital. The latter model was further facilitated by accounting rules that allowed “shadow” assets to be hidden off balance sheet.

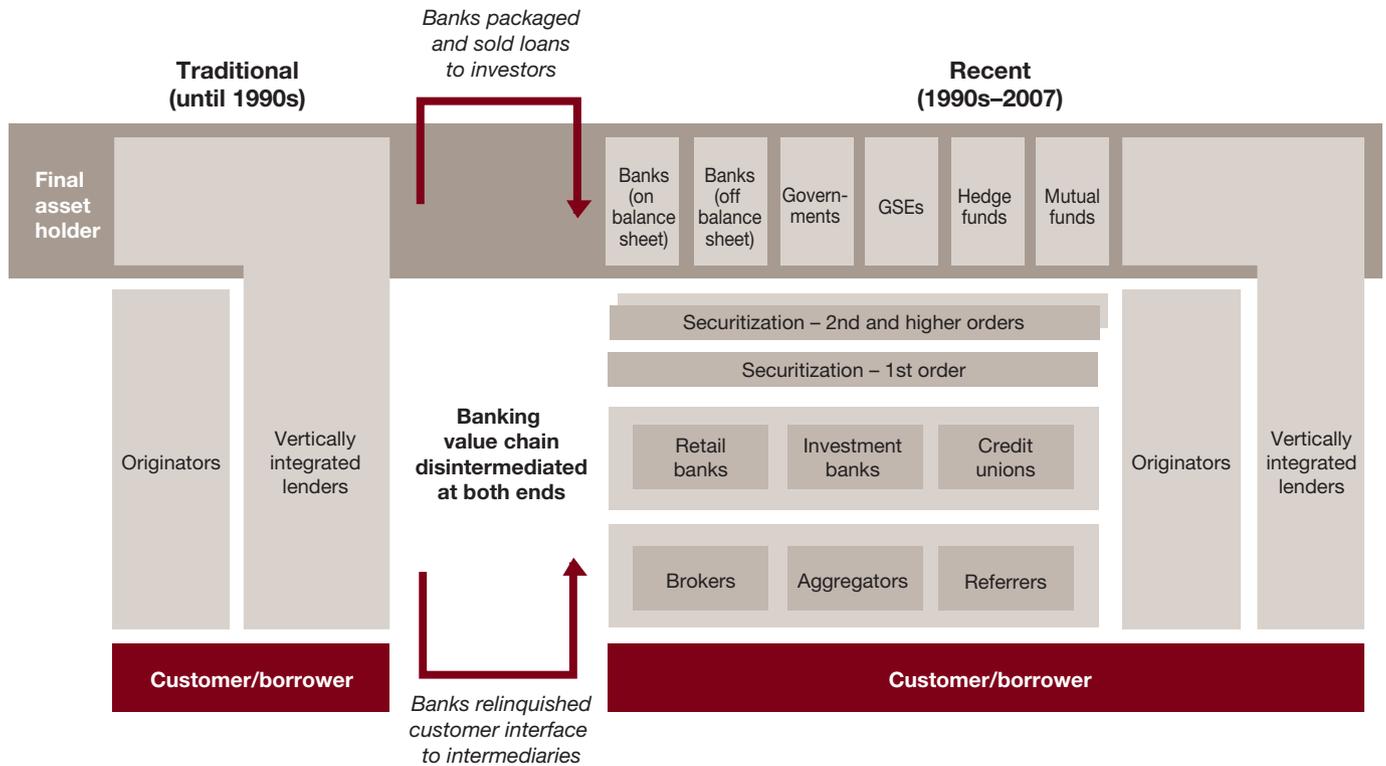
Starting in the early 1990s, the banking value chain was impacted by discontinuous changes at both ends. Banks relinquished the customer interface (and resulting information flow) to a host of intermediaries including brokers, aggregators, and referrers (*see Exhibit 3, next page*). At the same time, they packaged the resulting loans into securities and sold them to investors, who saw them as a new — and apparently high-yield — asset class.

This trend was driven by three interlocking and reinforcing factors:

- **Product innovation:** The “tranching” of securities according to risk and return, and the variety of product innovations it stimulated, allowed investors to choose among levels of risk and be compensated accordingly, at least in theory. Unfortunately, these new asset classes also facilitated the expansion of leverage to unrealistic levels and separated assets from the capital supporting their associated risks.
- **Originate-to-distribute model:** The new business model compensated banks and their third-party originators for the volume of loans originated. It should come as no surprise that banks came to focus on distribution reach and became less concerned about underlying asset quality.
- **Reliance on external rating agencies:** The unbundled value chain might have been sustainable if investors were able to accurately gauge the quality of assets they were buying. Unfortunately, rating agencies were paid by the same institutions that were issuing these securitized assets and, in some cases, actually worked with them to

Exhibit 3

The unbundling of the banking value chain



Source: Strategy&

reach desired rating outcomes. At the same time, many financial-services products became more complex and difficult to analyze. As a result, the effective credit analysis of institutions and, in particular, investment products became compromised, as evidenced by the elevated number of defaults in highly rated securitized products.

The crisis forced bankers to recognize that by shifting ownership of loans — and the customer relationships that they represent — to others they reduced transparency and increased risk. To reverse the situation, they must reassert that ownership, and leverage the resulting information flow for more effective risk management and value capture.

New lens on value in a low-growth environment

A rising tide lifts all boats — and there were few exceptions to this rule in global banking between 2001 and 2007. During this time, many banks took advantage of favorable margins and thin capital buffers to set hurdle rates for return on equity of 20 to 30 percent. They relied on a simple formula for success: Increase cash earnings by 10 to 12 percent annually by growing revenues in the high single digits and keeping cost increases in the low single digits; use high dividend payouts to add another few percentage points to shareholder returns; and exploit their own high (and continually rising) price/earnings ratios to offset the low beta and cost of capital in the banking sector.

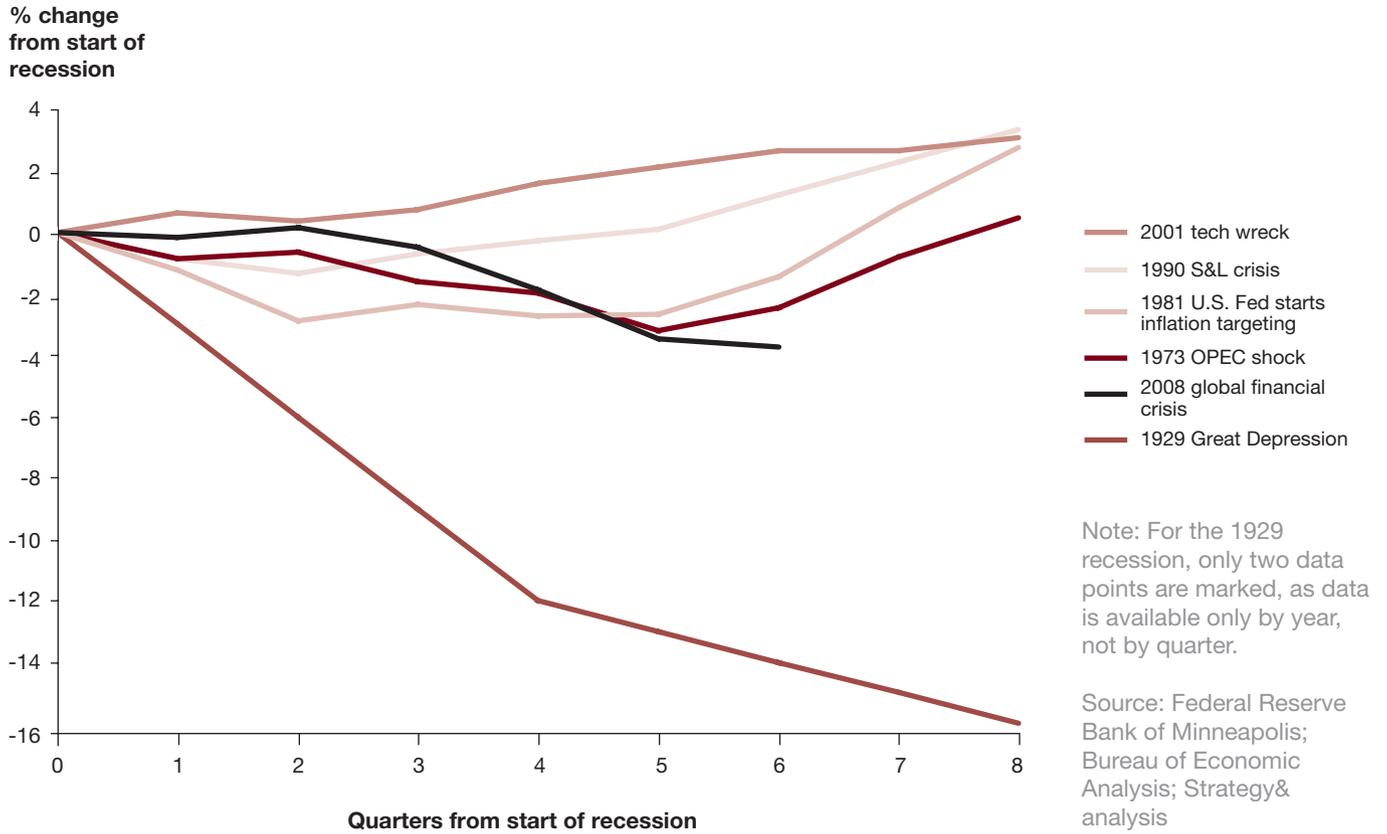
Clearly, this equation will no longer work. **First, a quick economic rebound is unlikely.** The current slump has already cut deeper and lasted longer than any recession to hit the U.S. economy since the Great Depression (*see Exhibit 4, next page*), and its impact around the world on consumer buying patterns continues. Beyond the standard boom and bust cycle, this crisis is underpinned by fundamental structural imbalances that will take years, even decades, to work through, such as the U.S.–China trade deficit, the mismatches in eurozone growth rates, the size and likely duration of the U.S. budget deficit, and the disparity between personal saving rates in Western and Asian economies. As a result, asset growth will be significantly subdued and it is likely that the banking sector's margin expansion of mid-2009, which occurred in response to a restricted supply of credit, will not be sustainable.

Second, keeping cost growth low will not be sufficient, and reducing absolute cost levels will not be easy. Low growth in assets and a weak pricing environment in the medium term will require banks to keep a tight lid on costs just to maintain their margins. However, the need to comply with increasing regulatory demands and to invest in a significant refocusing of capabilities — both prerequisites for operating in the post-crisis environment — will create upward cost pressures.

Third, the price/equity ratings of banks will languish. Banks can no longer afford to pay out large amounts of their free cash flow in the form of high dividends to attract investors and bolster their P/E ratings.

Low growth in assets and a weak pricing environment in the medium term will require banks to keep a tight lid on costs just to maintain their margins.

Exhibit 4
Quarterly GDP change in major U.S. recessions



In addition, their P/E ratings are likely to reflect an expectation of lower risk and return signatures over the medium to long term.

To see how conditions like these have played out in the past, it is worth revisiting the last major recession, in the early 1990s, and the asset clearing period that followed. In that recession, margins initially widened as banks were able to pick and choose customers and dictate loan terms. Profit growth was generated mainly by working out bad debts. But margins soon shrank: Increased competition created rising costs at the same time that bad debts were resolved and the burden for generating growth shifted back to cost reduction.

The early signs from the current recession suggest that a similar pattern is developing. Already margins are widening as nonbank and foreign competitors exit markets and the remaining banks use this opportunity to reprice lending, especially in their loans to businesses. However, this is likely to provide only temporary relief. Competition will increase as stronger players use this opportunity to reposition and enhance their market share, and in the medium term, securitization and nonbank lenders will reemerge, driving renewed competition and, with it, continued margin compression.

A capabilities-driven approach to banking success

While the developments described above do not change the core capabilities required for banking success, they do require that those capabilities be retooled to better respond to the demands of the post-crisis environment. Each of the three developments has specific implications for the core capabilities of banks (*see Exhibit 5, next page*).

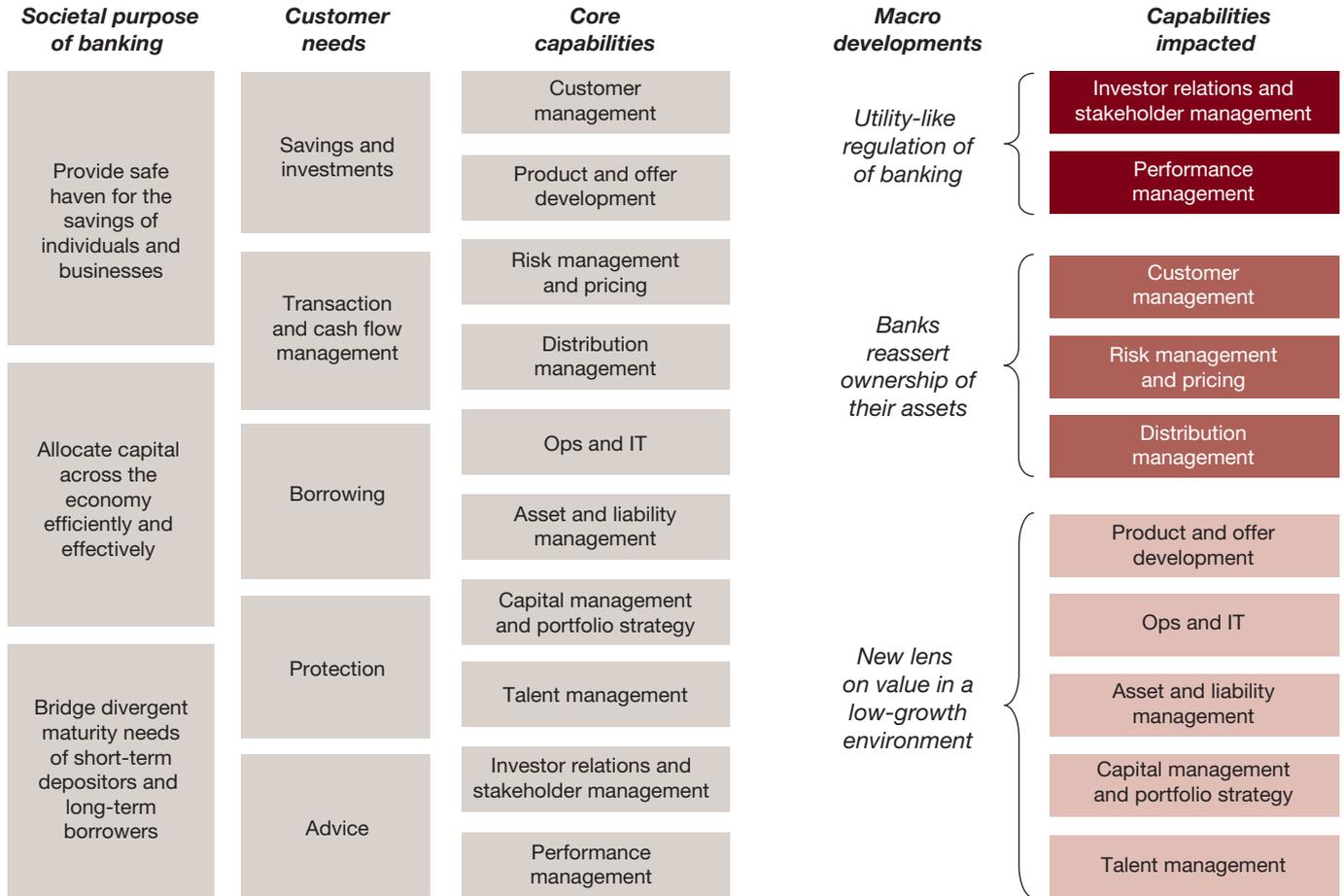
The three sections that follow, and the key questions and recommendations within them, are designed to assist executives as they evaluate the current capabilities of their banks and gauge their capacity to cope with and profit from the post-crisis banking landscape.

Exhibit 5

The capability impacts of the three major developments

The fundamentals are unchanged ...

... but how banks deliver critical capabilities is being impacted by major developments



Source: Strategy&

Managing the rising regulatory burden

As banks face the need to be more proactive in dealing with governments, and are required to provide more transparent and relevant information to investors and other stakeholders, they will need to address two sets of questions:

1. Do you have the investor relations and stakeholder management capability necessary to influence the policy decisions and regulations being considered within your bank's geographic footprint?

Banks need to enhance their stakeholder management capability to earn a seat at the table and influence outcomes before, not after, the new regulatory landscape is mapped out. This is especially critical given the wave of negative publicity that is confronting both the banking sector and the policymakers who are perceived to be propping it up. To counter this, banks must be able to proactively engage government officials in the following ways:

- Articulating the fundamental social roles of the banking sector and fully explaining the implications — positive and negative — of increased regulation and intervention.
- Showing that they understand the needs and objectives of public officials, particularly the need for systemic stability, and helping to achieve those objectives in a manner that supports rather than undermines the goals and priorities of banking institutions.
- Demonstrating on an ongoing basis the steps that banks are taking and the progress they have made toward restoring confidence and stability, particularly around compensation and risk management. The recent and very public efforts of some Australian banks to reduce executive salaries and exception fees are a good example of this approach.

2. Does your performance management capability include metrics that reflect your organization's broader role in society? Are those metrics properly balanced, as well as transparent to stakeholders?

Regardless of the degree of regulation and government ownership that arises from the crisis, banks must be prepared to respond to demands for much greater transparency from all of their stakeholders — including shareholders, governments, and communities.

- No longer can metrics be focused solely on short-term financials, such as profit growth, cost to income performance, and dividend payout ratio; they must expand to include longer-term measures that offer insight into funding durations, loan to deposit ratios, and capital management through the economic cycle.
- Banks must prepare to report in greater detail on a variety of factors — such as capital base, asset quality, compensation, and risk and derivative exposures (by industry and country) — that concern the full spectrum of stakeholders, both public and private.
- Banks must begin to augment reporting with metrics that demonstrate their contribution to systemic stability as well as strong institutional performance.

Redesigning value chains for renewed customer ownership

In the post-crisis era, as global financial markets deleverage, banks will have to reevaluate and redesign their value chains. They will return to more vertically integrated management systems, bringing their underlying assets closer so they can better assess risk, safely deploy their balance sheets in an environment of scarcity, and maximize value capture. This raises three sets of questions about a bank's capabilities:

1. Does your customer management capability enable you to get close enough to the customer? Are you collecting the right customer information? Are you leveraging this information to greatest effect?

Bankers now realize that their core asset is their customer base, comprising both individuals and businesses. A well-honed customer management capability — one that enables them to engage, win, and retain customers — will enhance both revenue generation and risk management. Those banks that still have product-defined organizations will have to rapidly rethink how they can create a targeted customer-centric orientation.

Customer insight is the key to success in this shift. Like most other businesses, banks need to sharpen their capability for capturing customer information in a timely manner — for banks, this means analyzing their customers' product holdings, cash flows, behaviors, and personal circumstances. Depth of relationship will be more important than breadth. For example, it will be more valuable for a bank to have an 80 percent wallet share of 1 million customers than a 10 percent share of 8 million customers. Greater wallet share permits greater insight into buying patterns, credit risk, and churn potential, enabling a stronger, more profitable lifelong customer relationship. Customer and decision analytics, which are too often relegated to credit card departments if they are present at all, will now become a critical capability.

2. Are your risk management processes optimized for efficiency and effectiveness? Are you confident in your risk pricing approaches? Does your asset workout group have the right skill set?

As they forge closer connections with customers, banks need to revitalize their risk management and pricing capabilities. They must ensure that they are pricing accurately for risk and fully leveraging the improved information flow that will result from “natural ownership” of their assets.

Both the efficiency and effectiveness of risk processes must be improved. To enhance efficiency, banks can revisit their credit processes and ensure that they are properly aligned with the organization’s risk objectives. A “triage” approach provides abbreviated or short-form processes for existing customers or for refinancing, leaving full analysis for higher-risk prospects. To enhance effectiveness, banks will need to assess the quality of information being used to feed their risk models, as well as review risk management approaches within the different parts of their portfolios. For risk-assessed loans, banks will need to augment external ratings with a more robust internal analysis of risk and pricing. This will have an added benefit in terms of reducing systemic risk by broadening the base of information available to banks, minimizing their reliance on the narrow and potentially skewed analysis that resides at centralized credit bureaus. Because of the impact of unemployment and poor stock market performance, banks will need to account for altered risk profiles in their statistically managed loans; broad-brush approaches such as community-rated pricing will prove less competitive as more sophisticated competitors cherry-pick low-risk customers. At a minimum, banks must augment their statistical risk assessment of consumer loans with more sophisticated use of customer behavior information.

Banks with large portfolios of bad debt will also need to retool their asset workout capability. The “bad bank” model used in Australia and the U.S. during the early 1990s may provide a useful model for isolating bad loans in separate business units instead of offloading them at deep discounts. This grants some measure of protection to the larger organization and enables the “bad bank” to focus on helping borrowers get off life support, restructure their businesses, and repay loans. Like private equity investors, bankers will need relevant operational expertise in addition to the classic financial reengineering skills, especially in geographies where nonperforming loans will force banks to operate significant numbers of companies for years to come.

3. Does your distribution management capability allow you to optimize control of the customer interface? How will your investor distribution capability respond to the likely reemergence of securitization?

Banks need to place less emphasis on third-party distribution channels. Instead, they need to focus again on establishing and developing customer channels over which they have greater control, either by direct ownership or through operational and platform linkages. These in-house channels will permit more targeted customer acquisition, service, cross-selling, and retention. They will require a distribution capability that enables banks to become increasingly sophisticated in how they define customer segments, design differentiated customer experiences that align with their brands, and deliver supporting value propositions. In particular, banks will need to be able to plan and deliver a targeted customer experience across an integrated suite of touch points. For example, HSBC has created a high-touch customer experience for its “premier” clients in Hong Kong. In addition to a branch upgrade that allows tellers to spend more time on service and less on routine transactions, these high-net-worth customers receive preferential counter service and pricing, supported by a 24-hour call center and a website providing an integrated view of both local and foreign currency accounts.

Banks will also need to reevaluate how they distribute loans off their balance sheet via securitization. The essential premise of securitization remains sound: For lenders, it provides an alternative means of funding and managing the balance sheet; for investors, it represents an asset class with tailored risk and return profiles. It is highly unlikely, however, that second- and third-order securitizations will reemerge, given the lack of transparency and unsustainable leverage they engendered. Instead, investors will conduct their own due diligence, demanding clear transparency into asset quality and first-order relationships with lenders. Banks that deploy their brands and provide superior reporting about the quality of their assets will command strong relationships with investors and maintain an edge over resurgent nonbank lenders. They may even be able to develop and market “branded” securitizations, in which the integrity of the originating institution becomes a key selling point to investors.

Profiting in a low-growth environment

Growing shareholder value in the post-crisis banking environment will require a comprehensive and balanced approach to both financial and nonfinancial capabilities. Banking leaders must augment their past focus on revenue and cost with a more sophisticated approach to capital. At the same time, successfully responding to the scope and scale of change will demand that banks revisit their people processes and underlying cultures. Five sets of questions need to be considered, by the CEO and executive team and in more detail by functional leaders:

1. Do your product and offer development capabilities enable you to leverage your brand in developing long-term customer relationships? How will you use your brand to earn the chance to satisfy a broader set of customer needs?

In the post-crisis era, customers will increasingly concentrate their business in banks they perceive as stable, secure, and able to provide the products and services they require. Winning these customers and the greater wallet share they represent will require banks to provide the proof points of security and longevity needed to secure their trust. As the industry consolidates through mergers and acquisitions, and global universal banks face the challenge of retaining and strengthening their connections to larger numbers of customers, the ability to create and demonstrate brand value will be key to building this trust, as will the ability to manage and align multiple brands. Meeting a full range of customer needs will provide a level of return beyond what can be derived solely from deposits and loans. Banks will increasingly offer services such as cash flow management (especially as customers respond to changing personal situations and budgets) and new forms of financial advice, with a likely greater focus on transactional support over the traditional holistic approach. Bancassurance represents another critical opportunity; with the destruction of wealth in stock markets and other investment channels over the last year, banks can expect to see a strong and growing demand for simple wealth creation and protection products such as mortgage protection, income protection, life insurance, and health savings accounts.

2. Do your operations and information technology capabilities enable cost reduction and productivity programs that attack structural cost drivers? Are you aligning your business architecture around customer-centric imperatives?

Over the past decade, many banks have focused their efforts on cost reduction, but for the most part, they have not been able to achieve reductions sufficient to compensate for shrinking margins — so that overall returns on assets have been flat or declining. Further cost savings are hampered by two obstacles. First, cost efficiencies have typically been driven by process improvements that have leveraged an end-to-end product view. Now, however, banks find the resulting product-aligned architecture to be at odds with the need for greater customer-centricity. Second, a large portion of operational savings has come from outsourcing and offshoring, but these options will likely become more difficult to exploit, given the increased taxpayer funding of banks and associated public scrutiny. In fact, some CEOs have already publicly ruled out offshoring in an effort to improve battered corporate reputations and brands.

Many banks will thus need to develop better operational and IT management capabilities to attack the structural drivers of cost and achieve customer-centricity. This is a major, near-term opportunity for many banks to reinvent their systems architectures at the same time that they replace core mainframes that date back to the 1970s or earlier. In parallel, banks can overhaul the associated business models and structures that are inhibiting customer-centric innovation.

The cost drivers in most banks are deeply embedded in their legacy process, technology, and product architectures. They are best addressed by fundamentally realigning the structure of the business around customer needs, rather than overlaying new operating models and IT systems on legacy product-based processes and organizational structures. Greater customer-centricity will permit a more sophisticated understanding of the drivers of customer value and their cost. In turn, this will permit banks to deliver “smart customization” — streamlining and consolidating delivery of customer “nonnegotiables,” while charging appropriately for extra features that customers actually value.

3. Do your asset and liability management capabilities enable you to manage your funding mix holistically? How well positioned are you for the coming scramble to attract deposits?

Easy access to low-cost wholesale funding during the pre-crisis era caused many banks to lose sight of the role of deposits as a critical source of funding. Too often, deposits were treated as a consumer banking product, and were managed in a fragmented manner across

Many banks will need better operational and IT management capabilities to attack the structural drivers of cost and become more customer-centric.

multiple lines of business. Now, however, banks must manage their cash holistically and on a group-wide basis. In fact, the banks that already do this have a distinct advantage in the post-crisis era and in some cases have emerged as aggressors in M&A deals as markets consolidate.

The recent dramatic rise in saving rates in developed economies represents another major opportunity for banks to shore up a critical gap in their customer offerings while more proactively managing a core element of their funding mix. Capturing these new deposits will require banks to apply a level of sophistication to product innovation and pricing that was previously applied only to the asset side. Banks will need to use increasingly sophisticated customer analytics to understand the drivers of customer value and retention and to analyze elasticity and demand in their efforts to optimize pricing.

4. Do you have an integrated capital management and portfolio strategy capability? Are you managing capital as a strategic asset? What alternatives do you have if current funding sources dry up?

Capital is now acknowledged as a critical strategic asset and needs to be managed as such. A restricted flow of capital destroyed institutions such as Bear Stearns and Lehman Brothers, while more savvy stewards of capital such as JPMorgan Chase and Goldman Sachs are emerging from the crisis as clear winners.

But it won't be enough to manage capital strategically. Banks must also effectively communicate their strategy to investors, particularly as they seek to expand. Big is no longer beautiful unless it leads to a firm that is better aligned with its core value proposition and delivers an attractive, sustainable return on capital. Shareholders will no longer tolerate empire building for its own sake but will expect to see a compelling business case for each M&A deal, as well as subsequent reporting around deal performance. Shareholders will also expect to see how specific deals fit into a broader M&A and capital management agenda that includes divestments as well as acquisitions.

To securely fund business growth in the coming era, banks will have to diversify their funding base. For debt, this will mean diversifying duration; in fact, regulators in some countries are already moving to mandate longer-term requirements. For equity, it will mean thinking ahead about alternative sources of capital before they are needed, including strategic investors and sovereign wealth funds.

Banks will also need to reset the expectations of equity markets. The low-risk, high-return proposition that the banking sector implicitly promised investors has proven illusory. Banks can no longer afford high dividend payout ratios or use leverage to generate oversized returns on

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equity. Shareholders are now presented with a less attractive, although arguably more sustainable, opportunity that can best be summarized as “low risk, low return, but low volatility too.” Banks need to set and manage this expectation proactively.

5. Does your talent management capability support the human capital requirements of the post-crisis era?

The last decade has seen an increased trend in banks hiring from outside the financial-services sector, focusing on functional skills like marketing that were thought to be transferable. Today, banks need more holistic expertise; a single executive might need to be fluent in customer analytics, asset and liability management, distribution, products, and operations. This highlights the value of a more traditional rotation model, in which well-rounded, high-potential bankers are groomed for senior leadership by serving in multiple functions during their careers. And it further reinforces an already existing shift from talent recruitment to talent retention and development.

Important cultural changes will also be required in the aftermath of the current crisis. The need for a holistic view requires effective teaming at senior levels and the elimination of the “cult of the leader” phenomenon that creates barriers to collaborative management. Banking cultures will also become more outwardly focused: They will center naturally on the customer, and will work with regulators, investors, and communities in a more inclusive way.

Improved capabilities: The keys to success in banking's new era

Banks — whether government controlled or privately held, whether specialist, regional, or universal players — are still the heart of the global economy. They pump the funds on which productive human enterprise depends. Banks must perform this role effectively with all the due diligence we would expect of any custodian of such an essential role.

Banking must refocus on those fundamentals that are unchanged by the financial crisis — their core purpose, customer needs, and capabilities — while recognizing that profound market changes have occurred and will impact how these capabilities need to be delivered. Those leaders whose banks can respond to the times and enhance their capabilities will be tomorrow's winners.

How ready are you to compete in this new era of banking?

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This report was originally published by Booz & Company in 2009.

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