
BEST-PRACTICES FOR BANKS IN CHALLENGING TIMES

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“Increasing Bank Profitability at Acceptable Risk”



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SUMMARY

Banks all over the world are grappling with two groups of challenges:

- First, there are the normal challenges from being in banking
- Second, there are the extra challenges that arise from the global banking crisis

The combined impact of the challenges means that the pressure on banks to establish best-practices has never been greater. Some banks are responding well and prospering. Others are making few changes and seem to be in peril.

This paper summarises the best-practices being introduced by well-managed banks around the world to upgrade their business strategies, organisation structures and management methods to world-class levels. These best-practices aim to correct the weaknesses revealed in many banks by the ongoing global banking crisis and to meet the growing demands of customers, regulators, shareholders and the boards and top executives of well-managed banks.

THE CHALLENGES

Banking was becoming a difficult business even before the current crisis afflicting banks worldwide – one in which it was hard to make consistently high returns on capital. The challenges were “normal” – the result primarily of growing competition in a mature business. Other new challenges have arisen directly from the global banking crisis that looks set to continue for many more months, possibly years.

Normal Challenges

In many countries, several developments are squeezing banks' profit margins. Deregulation is increasing competition between banks and this forces them to reduce their prices. At the same time, new entrants to banking are being allowed, for example, foreign banks, insurance companies and even retail stores. Some of these new entrants are attacking the market with cheaper, more customer-friendly delivery channels which old-fashioned banks with traditional branches find hard to compete with. Disintermediation also means that some banks are losing business to investment banks and asset management firms. This loss of business has been most serious with corporate business but now retail business is being lost as well.

Taken together, these developments are, generally, eroding bank profitability and forcing banks to make major strategic changes. Some banks have responded well and are “winning” but others are “losing” and are in decline. One key characteristic of the “winners” is their readiness to adopt best-practices for most or all of their key businesses and management approaches.

In most countries, these normal challenges still exist and, in some markets, are actually becoming more intense. They continue to be a key reason why well-managed banks are adopting best-practices.

Banking Crisis Challenges

While banks were wrestling with these normal challenges along came the banking crisis or “credit crunch” as it is popularly known. The causes of the crisis are still the subject of fierce debate between bankers, regulators, governments, supranational institutions such as the IMF and World Bank, and academics.

Whatever the causes and whoever is most to blame, the whole saga has created a new set of big challenges for banks. Even some of the most illustrious banks in the world have much to do to restore their former glory. The range of challenges is wide. Some banks have to rebuild their capital bases and, in some of these cases, this means replacing government shareholders (who came in to rescue their banks) with private shareholders which are either institutions, or companies or individuals - or all three. For some banks, the biggest and most daunting challenge is to win back customers which were a major source of deposits but which felt the need to diversify the banks with which they deposited. Another funding challenge is to reactivate inter-bank funding by contributing to confidence-building among banks.

A special challenge for some banks revealed by the banking crisis is the need to build deeper and more specialised skills that are clearly required in modern banking. These banks now realise that even at the highest levels – the board and top management – they need much greater familiarity with corporate governance and the full range of best-practices, as well as with a range of technical matters such as the risks arising from derivative instruments.

An important part of overcoming the banking crisis relates to restoring confidence between banks, shareholders, customers and regulators. Confidence will grow again as profitability increases and risks are brought under tight control. Implementation of best-practices can make a major contribution to increasing profitability and upgrading risk management. As a result, they are valuable to banks in meeting the challenges from the banking crisis.

THE BEST-PRACTICES

Best-practices in banking aim to increase profitability at acceptable levels of risk. They relate to boosting income, upgrading risk management, increasing cost-effectiveness and optimising resource allocation – the four main drivers of bank profitability – and to building strong corporate governance which is increasingly recognised as fundamental.

Boosting Income

The main ways well-managed banks increase income is by “segmenting & focusing their marketing efforts”, and “selling & cross-selling intensively”.

Segmented & Focused Marketing

For marketing, the best banks divide their customers into different market segments such as personal, premium, private, SME, corporate and institutional segments. These vary in terms of services needed, service quality levels and delivery channels preferred, and prices offered. Very often, different types of bank personnel are assigned to serve the different segments. By choosing the best combination of market segments, well-managed banks aim to increase profitability by focusing business development on to segments that yield the highest returns – a move that can increase bank profits by 20% to 30%.

Today, it is noticeable that many banks are giving more attention to the higher yielding personal (retail) and SME segments. For these segments, product ranges have been augmented, especially by the addition of more credit card, mortgage, insurance, investment and advisory services. Products are designed, “packaged” with other products, and “branded” for different segments. Special emphasis has been given by some banks to deposit product packages. It is now common to find banks selling over 50 deposit packages while other banks still only provide 3, 4 or 5 basic deposits.

Very importantly, there is a clear move away from large, traditional, multi-segment branches to delivery channels that are designed for different segments, for example, smaller segment-specific branches, plastic card channels and electronic delivery via advanced ATM’s and Internet, phone and SMS banking.

Intensive Selling & Cross-Selling

With selling and cross-selling equally important changes have been made. The average bank in Europe and the USA still only devotes around 10% of its total time to selling in the sense of communicating with customers with the clear aim of getting them to buy something. “Bureaucratic” banks devote only 5% or less of their time to selling but the leaders spend over 20%. Not surprisingly, the leaders are those that win market share, cross-sell more services and achieve higher levels of profitability.

Banks that are keen to intensify selling make many changes. Existing jobs are redesigned so more time can be spent selling. Personnel are moved from non-selling jobs into those that involve selling. New types of selling job are created. As examples, some banks now have large mobile sales forces and are very active in selling via telephone selling, websites, mass-emailing and mass-SMS messaging.

To achieve and maintain highly intensive selling, major changes have also been made to the ways that selling success is measured, managed and rewarded. Nearly all banks have a credit policy manual but most still do not have a “sales manual” or even a “product manual”. Things are different in the best banks where selling is now managed with the same rigour as credit.

Upgrading Risk Management

Basel II and the banking crisis are forcing banks, worldwide, to upgrade risk management, especially the management of credit, market and operating risks. Some banks have made impressive progress while others have lagged behind.

World-Class Credit Management

The biggest risk faced by ambitious banks that intensify selling is that they might sell bad loans. To counteract this risk numerous improvements have been introduced. Credit policies are segmented and based on a deep understanding of the historical and expected future credit performance of different segments. They are no longer just judgmental “guess work”.

Credit appraisal methods are “scientific” and include credit scoring for the personal and SME segments and expert systems for corporate borrowers. Risk-adjusted pricing (RAP) is now common to ensure an adequate return on lending. To cut the operating cost of credit management, which is often very high, numerous new systems have been introduced. Loan applications processing and early warning systems, such as risk grading and dynamic behavioural scoring, are automated. Even remedial management and recoveries are heavily dependent on modern systems such as power-dialling. The range of portfolio monitoring and management models now used is also impressive.

Without doubt, credit management has become “hi-tech” and the results show in the performance of the best banks.

World-Class Asset & Liability Management & Treasury

Commonly, traditional banks think they make most profit by lending money, taking credit risk, but often this is not the whole truth. The best banks know that they also make money by taking the market risks that arise from transforming asset and liability maturities, converting currencies and investing in marketable securities. They seize the opportunities to increase bank profits, and to make them less volatile, by adopting a centralised-active approach to asset & liability management (ALM). In such banks, top management spends far more time on ALM and arranges for the necessary analytical support to be available. Top-level Asset & Liability Committees (ALCO's) spend most time evaluating alternative A&L policies and translating them into operating guidelines for treasury units, at home and abroad, and the other business divisions. Profits are measured using mark-to-market methods as opposed to old-fashioned (and inaccurate) cost-of-funds methods. Risks are measured by value-at-risk (VAR) techniques that use Monte Carlo risk simulation.

The economic impact of world-class ALM is usually profound over 1 or 2 years. Many banks have doubled their profits and reduced their dependence on credit margins that are in general decline and are often volatile.

Increasing Cost-effectiveness

To support and complement their efforts to increase income and upgrade risk management, leading banks have also made strenuous efforts to increase cost effectiveness via reorganisation and reengineering.

Reorganisation

Historically, most banks were organised around territories: areas and/or regions. Branches in the home country were grouped into regions. An international division managed foreign activities that were also subdivided by regions. Banks discovered that these territorial structures are too general and expensive, and do not meet the needs of different market segments and specialised functions, such as risk management, operations and IT. Leading banks have replaced them with market segment or functional structures. A typical segmented structure might include separate divisions for personal, SME and corporate customers and these divisions often have global responsibilities in international banks. Functional structures organise banks around those functions that drive profits and typically include divisions responsible for sales, risks and costs. Some banks have chosen a combined segmented/functional structure.

These modern organisation structures can take time to establish but the benefits have usually been great in terms of improving customer satisfaction, selling intensity, market share, risk management and bank profits.

Reengineering

Many banks have reengineered their management processes and operational procedures with the aim of improving customer service and bank profits. Sadly, many of these exercises failed and costs increased. Big money was spent on new computer systems but few benefits were achieved.

The simple truth is that for reengineering to succeed economically either, costs must be reduced, or income increased. This means that personnel must be cut or they must be reassigned to income-producing activities, mainly selling. In some countries, the law does not allow personnel to be separated. Reengineering can only produce real profit improvement if personnel are moved to selling jobs. In other countries, the law does allow personnel to be cut so banks in these places can benefit from both downsizing the workforce and moving people into income-production. Leading banks recognise this simple truth when they reengineer. They have clear targets for reassigning personnel to selling (often 15% to 20% of the workforce) or for separating people. The key is to achieve the best possible balance between people producing income with those involved in administrative, cost-creating jobs. A 50/50 ratio is world-class.

Optimising Resource Allocation

The need to defend and then improve profitability is compelling banks to allocate their resources in a way that is rational and preferably optimal. Three of the most important resources are personnel, capital, and investment in IT.

Reassignment of Personnel

Personnel are obviously key in a personal service business such as banking. They are also expensive and frequently account for around 60% of total operating costs. It is imperative that they spend their time in way that directly supports high profitability. This means that a high proportion of personnel should be involved in income-generating activities, particularly selling and providing service to customers.

A growing number of banks recognise that the assignment of their staff is far from optimal. Too many people and too much time are being consumed by tasks that do not increase income but simply create more costs. Over-bureaucratic operations and excessive administration are typical. Banks that decide to correct this situation do so by making the selling, reorganisation and reengineering changes described above. These changes nearly always call for a significant proportion of the workforce to be moved into income-producing jobs. The main investments needed are in retraining, staff relocation and new computer systems. The reward is much improved profitability.

Optimal Capital Allocation

When a bank lends more money to a customer or a market segment it is, in effect, allocating more capital to that customer or segment. The amount of capital is determined by Basel II capital adequacy rules or the capital adequacy regulations that apply locally.

It is clearly logical to allocate more capital to customers and segments that are more profitable or which offer greater promise in future. Commonly, capital is not allocated in this optimal way. This means that overall bank profitability is less than it could be. A frequent example of capital misallocation relates to lending to big companies, SME's and personal customers. In plenty of banks, most lending is to bigger companies and yet this lending is less rewarding than lending to SME's and/or personal customers. As a result, more capital has been allocated to corporate lending than to the other segments with the result that bank profitability has suffered.

The reasons for capital misallocation are many and varied. History and internal "politics" often play a part. Sometimes the problem is lack of good management information that reveals the true profitability of business. Frequently, all of these deficiencies can be found. Whatever the causes, the best banks are making determined efforts to ensure their capital is used in the best possible way so that overall return on shareholders' equity is high.

Realignment of IT Investment

Banks are increasingly dependent on IT with the money being invested in IT increasing steadily. Today, the average bank across Europe and the USA invests around 10-12% of its total non-interest operating costs in IT. 10 years ago this figure was under 6-8% in some banks. In future, it seems certain that the figure will rise inexorably.

Because of the large and growing sums of money involved, it is crucial that banks invest wisely in IT. Historically, most IT investment was in applications that improved major transaction processing, for example, payments, cheque clearing, money market and FOREX dealing, and ATM transactions processing. Relatively little was invested in IT applications that help to boost income-generation and tighten risk management. Economically, the most important contribution of IT investment was to improve cost-effectiveness - banks could handle more transactions without recruiting a large number of extra people. The impact on bank income and risks was very limited.

Surprisingly, IT investment in many banks still focuses on transactions processing with little computer power being used in support of income-generation and risk management. These banks are missing opportunities to get high value from their IT investment. The best banks are correcting this deficiency. Their IT investment portfolios are more evenly spread over applications that improve cost-effectiveness, boost income and strengthen risk management.

Building Strong Corporate Governance

The importance of good corporate governance in banks is growing all over the world and this importance has been re-emphasised by the banking crisis that, in some cases, has revealed serious failures of governance, even in some banks that were previously considered exemplary.

Shareholders, regulators, customers and correspondent banks are now insisting that the banks they deal with employ the highest ethical and professional standards, and avoid conflicts of interest. In a growing number of countries, improvements to corporate governance are being encouraged by the enforcement of governance laws and codes of governance. These laws and codes prescribe best-practice at board, top management and other levels. At board level, particular importance is placed on the role and composition of board governance committees, separation of the roles of chairmen and chief executives, the role and authority of independent directors, and the overall composition of the board.

Banks that do not comply with these laws and codes risk serious sanctions or even being closed down by the regulators. Some may find that their poor governance is acceptable in their home market but unacceptable abroad. In these cases, continued representation abroad, or international expansion, are likely to be frustrated or impossible.

This article focuses on moves by leading banks to boost income, upgrade risk management, increase cost-effectiveness, optimise resource allocation and build strong corporate governance. These are what drive up bank profitability. However, many other supporting changes are usually needed. These matters will be covered in future articles that will deal with the introduction of modern approaches to strategic planning, action planning, budgeting and financial control: the upgrading of MIS and, crucially, in training and accreditation.

ABOUT THE AUTHOR

Chris Batt is an internationally-recognised adviser to the owners and leaders of banks, worldwide.

He is Chairman of Batt-Consulting, a specialised management consulting and top-level training firm that serves banks, worldwide. It is based in the UK and was founded in 1990.

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