cutting through complexity

Reshaping banking in a dynamic business and regulatory climate

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Overview

Facing profitability pressures, growing regulatory compliance costs, and revenue-growth difficulties due mainly to a shrinking net-interest margin and stagnant noninterest income, banking executives are increasingly looking to reshape their organizations' future, starting in 2013. Ironically, the reshaping has become necessary despite a much more benign credit environment today than has existed over the past several years.

For some industry stewards, the goal of kick-starting growth will require more than the current focus on cost-cutting and operational improvement. In our view, there must be acceptance among the entire leadership team that the rapid, unpredictable, and profound change we are witnessing in banking is structural—not cyclical.

After nearly five years of focus on survival, and as the industry is preparing to take advantage of an array of emerging positive economic indicators, we offer commentary in the pages ahead on a set of interdependent issues that must be recognized and managed as industry leaders adjust their attitude and embrace a culture of change—a concept not easily accepted in this tradition-bound industry.

With that acceptance—and with more clarity about the implications these new regulations will have on overall operations—banks can turn their focus to building new business models, creating new strategies, and crafting new infrastructures that will connect with existing and new customers. We believe the real debate is not about the need for change, but what changes should be made—and, very importantly, how to bridge from where the organization is today to where it needs to be to compete effectively going forward.

Building on the acceptance of change, bank leadership must execute on their strategy based on their organization's strength, maintain a relentless focus on customers, team with the third parties that complement their strategy, make tough decisions on the talent required to carry out the organization's strategy, and then be focused and thorough in managing operational performance.

The issues that must be confronted are many, they are connected, and they are evolving rapidly. As much as these issues involve people, processes, and technologies, they also deal with attitudes and culture. Without committing to change, the industry's executives will face significant impediments as they wrestle simultaneously with managing capital, regulation, operations, infrastructure, products, risk, pricing, alliances, and data management.

With this publication, we offer views about some of the key issues that currently are shaping the industry. Our intention is to spark debate, not necessarily to seek consensus. In the end, our hope is for many voices in the industry to join the discussion about the implications of today's issues on the future direction of the industry.

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A culture of embracing change

In the conversation on a new way forward, the topics of change and culture cannot be discussed separately. The conversation begins with the recognition that the path toward reshaping the industry is not only paved with good intentions, but also littered with barriers that can stifle new ideas.

The first step requires a penetrating evaluation of the organization's businesses, alliances, partnerships, products, and services. With that insight, banks can decide where to best compete—in terms of customer segments and geographies—in a radically different marketplace where margins are thinner than they were just a short time ago.

Banking leaders must choose to adapt and evolve, or risk irrelevance. In the future, when banks look back on this time of change, an organization's resilience will not be measured by how much adversity it endured throughout the financial crisis and this period of recovery; rather, it will be measured by how well it adapted to it.

The creation of new operating models to address revenue and profit declines is nothing new for banking, or for virtually any other industry for that matter. Often, though, attempts to create new ways to operate have netted less-than-desirable results. But the cause of these failures generally is not that there have been poorly designed strategies. Instead, the cause frequently can be traced to a rigid internal resistance to change and a consequent inability to execute.

Asked as part of recent news article about what part of his job frustrated him most, the chief executive of an automaker said: "Resistance to change. … You have to create a culture that not only accepts change but seeks out how to change. It's critically important that we inculcate that into our culture."[1]

Our experience in banking and other industries indicates that leading organizations understand that change is constant, that being nimble and innovative is core to success, and that they must be in a constant state of managing change. These kinds of organizations learn to embrace change; they take the long view that it is central to success and can never be viewed as something that interrupts business. With those views, banks can begin to ingrain procedures that consistently reassess the business from a process and risk-management point of view.

Inculcating a culture of change and its acceptance is difficult. It has no chance of success, unless driven from the top, starting with the board of directors and senior leadership. There is an increasing level of discussion in bank boardrooms about the need to embrace a different culture within the boardroom, where directors act as catalysts for driving the culture throughout the organization. This notion of cultural change is encouraging, because without it all the efforts to respond to the challenges presented by the reality of the new marketplace will be for naught.

Forward-looking banking leaders adapt to adversity by immersing themselves in a culture of acceptance. They believe that, while they have a choice about *how* to adapt, they have no choice *but* to adapt.

[1] "GM CEO Dan Akerson: Our Company Has a 'Resistance to Change,'" The Associated Press, December 11, 2011

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Focus on customers, not products

If banks expect to get more from the revenue spigot, they must figure out which customers to target, which to cut loose, and how to package the products and services customers want, *and are willing to pay for*. That won't be an easy task, given that the industry's reputation has taken a sustained beating for its role in the creation of the financial crisis, for some perceived missteps in attempts to boost fee income, and recent scandals involving the alleged rigging of borrowing rates and high-impact failed trades.

We believe that meeting the challenges around boosting revenues from customers, hinges on several critical imperatives:

- Becoming proficient at quickly gathering and leveraging the valuable structured and unstructured data about their customers—and their new target customers
- Gathering the data on customers and behaviors that is often buried deep in the banks' data mines, and in third-parties' repositories; banks will need to purchase that data, or form alliances with the third parties to access it
- Determining how best to monetize those sources of value

Although the challenges are clear and the options to move forward are fairly well known, a disconnect remains between many banks and their customers. Driven by advances in technologies already adopted by other industries, consumers are demanding the same from banking, but the banking industry has been slow to adapt.

At the same time, non-banks are snatching market share, fees, and other income at an ever-increasing rate. These non-banks include peer-to-peer lenders that are tapping into retail borrowers, private equity firms, hedge fund businesses, insurance companies that are lending more often to corporate borrowers, and payday lenders that are reaching the under-banked market. And this list does not include the much-publicized initiatives of technology and other firms to attempt to "disintermediate" banks in the areas of credit and debit cards, payment systems, and the like.

A bold new environment in the banking industry already is beginning to emerge, and it is quickly changing from one that for generations was dominated by a product-driven mentality to one where there is clear focus on customer-centricity. Banks that ignore this reshaping of the industry risk being marginalized and tossed on the heap of irrelevance.

Who could have imagined just a few years ago that today a grocery store chain and a major retailer could (or would) offer mortgages and deposit accounts, and that technology companies could launch payment systems and tools that allow pools of individual savers to offer borrowers much-needed personal and small-business loans?

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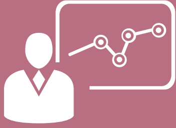

Deriving value from data

The banking sector has reached the point where it must decide whether it can turn customer insight and analytics into true competitive advantage. Banks must extract significantly more value from their data assets—both internal and external—if they are to stave off the disruptive threat posed by new entrants into the market and ensure that value is not lost. The real competitive advantage will go to those players who are able to successfully combine data from all available sources to develop a better understanding of customer needs and, as a result, serve them more effectively and profitably.

While banks realize that more can be done to capture value from existing internal data, it is a challenging task that is easier said than done.

In most cases, banks are saddled with complex and product-centric legacy systems that simply are not capable of delivering a single customer view across all products and geographies. An overall lack of funding and resources for customer insight and analytics also slows progress. Many banking staff members within their organization's analytics department suggest that the function is only a moderate strategic priority for their banks. They say they believe there is a lack of awareness at the top of the organization about the value that customer insight and analytics can provide to the business. The simple truth is that many banks remain focused on product sales and, as a result, many see data analytics purely as a means to an end rather than recognizing the value of achieving a richer understanding of the customers themselves.

In the face of these challenges, banks should change tack to fully exploit the rich data they already own. This will require that customer insight and analytics teams will have to become much better at demonstrating the value they add to the business, while also developing a highly honed understanding of the business itself. It will also require executives and business leaders to become greater champions of analytics and work to instill an increased sense of analytical literacy across the organization.

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Mergers/acquisitions/alliances

For the past several years, innumerable predictions have been made about the coming "wave" in bank's mergers and acquisitions (M&A). A plurality of opinion has been that, at 7,200,[2] the number of Federal Deposit Insurance Corporation (FDIC)-insured banks in the United States is too many, and that the number will drop precipitously in the very near future.

There is precedent for the prediction: The number of FDIC-insured banks in the United States has declined 31 percent in the past 15 years, from 10,400. But in the past few years, the much-heralded wave has been, at best, a ripple. Yet again, this year there is no shortage of the same forecast.

Looking back, there were 236 deals announced in 2012, compared to 178 transactions announced in 2011, although the total deal value was lower in 2012 than in 2011, an estimated $13.7 billion, compared to $17.1 billion. The median price to tangible book value was about 115 percent in 2012, compared to about 106 percent in 2011.[3]

The reasons for the slow pace are well-documented: Potential sellers look back to just a short time ago and see multiples of better than two times book value, and they expect to return to those multiples in the near term. If not compelled to sell by regulatory or financial pressures, many sellers are having difficulty accepting that their institutions can no longer—at least in this market—demand historical averages when it comes time to sell. Buyers, for their part, are requiring a better perceived deal to make the transaction. The asset risks and continued slim margins are compelling acquirers to pay less than past multiples or find a "perfect fit" in order to display an accretive deal.

Bank acquirers have explored a number of transaction structures and risk profiles in the current environment. Recent transactions have predominantly been acquisitions of distressed banks by healthy institutions, but other structuring options—such as recapitalizations and pre-packaged bankruptcies—may become attractive in the near future to strategic and private equity buyers.

Going forward, we expect strategic acquisitions to be characterized by a bank's ongoing geographic expansion, desire for the enhancement of product capabilities, and cost-reduction opportunities. But, we also expect that the existing large bid/ask spread will continue, at least through 2013, which should keep activity relatively low.

Smaller institutions will continue to face profitability challenges and shareholder activism to sell—putting more pressure on them to merge, although we expect buyers to remain concerned about current price levels as well as issues associated with capital preservation and potential surprises.

The issue of whether to use stock or cash will hinge on the perception of marketplace improvement, which remains difficult to predict. Regardless, we expect very limited market permission for high-premium transactions, given ongoing and wide concerns about the strength of sellers' balance sheets. Such concerns will put a high premium on due diligence—proof of "health" and validation of strategic fit, as well as on the integration and value realization plan.

[2] Federal Deposit Insurance Corporation *Quarterly Banking Profile*, September 30, 2012
[3] "Bank M&A 2012: Dealer's Digest," *SNL*, January 4, 2013

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Technology

The "T" word—technology—sends shivers down the spines of countless banking senior executives and board members; they equate investing in new technology with placing an enormous bet at a casino craps table. It's hard to blame those who feel that way. After all, many technology-upgrade plans have been long on promise and short on delivery.

Nevertheless, the Achilles heel in banking today is an information technology (IT) infrastructure that is riddled with aging, temperamental, and disparate platforms and systems that have been stitched together during the mergers and consolidations of the past decade or more, only to be relatively ignored during survival mode of the past few years. But, like it or not, banking is a technology business, and the infrastructure of many banks needs immediate attention from an enterprise-wide perspective after years of bolting on new applications to exiting platforms.

The promise of harnessing advances in technology could not be more attractive in today's marketplace: streamlining operations to lower operating costs; connecting with existing and future customers across a multitude of new and emerging channels, expanding revenue streams, and enhancing customer loyalty; and building better defenses against the rising threat of cyber crime and denial-of-service attacks. Lofty goals, all of them, yet legitimate questions remain about whether banks have the capabilities, including technological know-how, to tackle those imposing imperatives.

In our view, a profitable and sustainable operating model in this industry must begin with leveraging technology for the "industrialization" of the internal processes that cross the distinct boundaries inside a bank's operations and distinct businesses. This industrialization of processes is designed to simplify, standardize, and consolidate as a means to reduce the complexity of operations, cut costs, enhance client service, and deliver bottom-line improvement. Industrialization—already installed or underway with a degree of success in other industries such as automobile, pharmaceuticals, computer, and insurance—will require a significant investment in time by people throughout the banking businesses.

Ignoring or putting off the inevitable is a risky strategy, especially with the risk of noncompliance with ever-more complex regulations that are demanding immediate responses and more transparency into processes, as well as the reputation risks that arise when a bank experiences a failure of its IT system.

Banks that do not address the pressing IT architecture issues increase the possibility of losing market share to others that are upgrading to take advantage of such advances as mobile applications that retail and business customers around the world are demanding.

Addressing such concerns will not be easy because, while customers say for example they want the convenience of mobile and online banking, at the same time they say they like to use a bank's branches and they want to be given very personalized service, all at a very low cost. That "I want my cake-and-eat-it, too" demand by customers puts the industry in a difficult position, although the banks that can meet both requests will be the profitable survivors in this ever-more competitive market place. The mobile and online banking features can reduce transaction costs and open new revenue streams, while the branch strategy can enhance the potential for customer loyalty, attract new customers, and create the potential for more revenue by cross-selling products and services.

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For some banks, the push toward a better online and mobile experience for the customer will require the creation of a strategic alliance or a joint venture. Many will not be able to go it alone due to resource or know-how constraints when it comes to such offerings as mobile point-of-sale payment capabilities, mobile bill paying, person-to-person transaction technology, or the ability for customers to make a deposit using a mobile device.

In the year ahead, a major agenda item for bank executives and their boards will be how they are going to use technology to build the bank of the future, given today's economic, regulatory, and customer realities. Will they employ cloud computing technologies? Will they keep certain proprietary capabilities inside the operation? Will they align with third parties to address demands beyond their current capabilities? In many ways, from a technology perspective, 2013 is lining up as a watershed year in the quest to reduce costs, expand revenues, relieve margin pressure, and make great strides at operational improvement.

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Cyber security

Hanging over the dependence on advances in technology is the threat presented by cyber attacks. With increasing frequency over the past year, major U.S. banks have reached out to the federal government for help in protecting their computer systems after enduring a barrage of assaults from hackers that have disrupted their Web sites. The implications for banks' businesses and customers are both enormous and unknown. In March, a U.S. intelligence chief told the U.S. Senate Intelligence Committee that cyber attacks against banks have grown in the past year and that tools to "steal, manipulate, or delete" information from inside the bank are not difficult for cyber criminals to obtain.[4]

While cyber attacks on banks and other financial firms are not new, the scope and frequency of recent attacks on large U.S.-based banks has raised the profile of the issue and prompted debate on how banks of all sizes will need to prepare for this risk. In September 2012, a number of denial-of-service attacks affected thousands of bank customers, and crippled banks' Web sites for an extended period of time. Most noteworthy was the global media consensus is, that the attacks were mounted by foreign governments with the intention of disrupting commerce, rather than by so-called "hactivists" as a form of social protest, or by cyber criminals intent on siphoning funds.

[4] U.S. Intelligence Chief Says Cyberattacks Could Disrupt Financial Networks, *American Banker*, March 14, 2013

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Capital – Regulatory compliance and a better balance sheet

At the start of 2013, when the U.S. Federal Reserve Bank, the FDIC, and the Office of the Comptroller of the Currency (OCC) announced a delay of four years in the implementation of new capital adequacy and liquidity requirements, it provided some relief. The banks were concerned that, by requiring more capital to be held, the rules would stifle the nascent economic recovery, limit banks' ability to lend to retail and business customers, and force them to pass added compliance costs along to customers through increased prices and fees.

But for many banks, whether large, regional, or community in size, the issue of capital may be secondary to worries about the ongoing staffing cost associated with proving to regulators that they are complying with the new capital and liquidity rules. Those worries are compounded, the banks say, when taken together with the compliance requirements for the many other new regulations such as mortgage servicing rules, derivatives reform, and Form PF, associated with the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank).

Had the deadline for the capital and liquidity rules not been extended, banks would have been required to hold enough liquid assets to cover their expected losses for a 30-day period beginning in 2015. Instead, that deadline will be phased in and will be final in 2019. In addition, there is now flexibility in the types of assets that can be considered liquid under the new rules.

While the delay of the capital and liquidity rules, based on the Basel Committee on Banking Supervision's Basel III accord, provides much-needed time, banks must not lose sight of stress test requirements from federal banking regulators as part of Dodd-Frank. While, for now, only a very small percentage of U.S. banks have been required to undergo the test, eventually many other banks will be required to follow suit. With that hurdle looming, bank leaders would be wise to get clarity on the yardsticks regulators will use to examine the stability and soundness of their bank's loan portfolio.

Regulators recently issued guidance about the test criteria, although many questions remain within the banking industry, particularly at the regional and community level. In October 2012, the OCC issued a set of guidelines aimed at banks with $10 billion or less in assets, emphasizing that the institutions should begin internal evaluations of individual loans and of concentrations of loans. While stress testing is time consuming, it may provide very valuable insights as part of overall strategic planning and on the organization's risk appetite.

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Accounting – credit losses

From an accounting perspective, banks also will need to understand a Financial Accounting Standards Board (FASB) recent proposal on major revisions to accounting for credit losses on financial assets. The proposal is aimed at improving the reporting on expected credit losses on loans and other financial assets held as investments by banks by requiring more timely recognition of credit losses, as well as additional transparency about credit risk. The standard would mark a significant change in accounting for credit losses by using a single "expected credit loss" measurement, rather than the current standard under U.S. Generally Accepted Accounting Principles, which require that a loss be "incurred" before it is recognized in financial statements. Such a change could not only have a significant impact on banks' reported earnings, but also on its capital ratios, by requiring larger loan-loss reserves and changes in the level of reserves that are counter-cyclical.

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About the author:

Brian Stephens is the national leader of KPMG's Banking and Capital Markets practice, which serves commercial banks, regional and community banks, investment banks and securities firms, and diversified financial companies. He has 33 years of experience in the banking industry serving large multinational and national banks, as well as other global financial services institutions.

bbstephens@kpmg.com

kpmg.com

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