

Progressing Financial Markets

PFM05 – Moving Forward

With Eric Leenders, Executive Director and Head of the Retail Banking Team at the British Bankers Association, and Vikram Lund, Director of the Banking Industry for North-East Europe at IBM

Mike O'Hara: Well, good morning gentlemen, and welcome to the Progressing Financial Markets podcast. Eric Leenders, if I can start with you. Some banks have seen their profits increase in recent months. Others haven't. To paraphrase Winston Churchill, is this the end of the beginning of the crisis, or is this just the beginning of the end?

Eric Leenders: I think so much of it is predicated by the current recession, and I think that we have to be very careful if we start to talk about “green shoots of recovery”. For me, I think that, just as there has been an emergent distinction in recent years between the economy and the real economy, I think we have to be quite clear in terms of retail banking of a distinction between the recession and the real recession. So if, as we have seen in France or in Germany, there is a return to GDP growth, well, in terms of the recession, that might be a good thing. But in the context of a real recession, well, I should think that a better indicator is levels of unemployment that I think are going to continue to peak. Now that plays through to retail banking models because, of course, in terms of asset quality and impairment, one of the strongest lead indicators is unemployment levels. And as they continue to rise, we would expect to see impairment continuing to rise. The other side of the pressure on impairment, of course, is base rate as a proxy for consumers' cost of funds. And presently, with a deflationary environment as determined by the Monetary Policy Committee, we see quite low rates. As risk is priced in, as base rate, as proxy for that cost of funds, starts to increase, you get a double whammy. You get increasing unemployment, and you get increasing cost of borrowing. Those two, I think, mean that, if we were to use the phrase “the real recession”, there is still some way to go.

Mike: So would you agree, Vikram, that this is probably the end of the beginning, as opposed to the beginning of the end?

Vikram Lund: Well, I think it's the million-dollar question, or I should say the million-pound question. I think it's very early to tell. I think that we are looking at an environment that compares the first half of 2009 to perhaps the worst compare, which was the first half of 2008. So relative to 2008, clearly there are some signs of improvement. But banks, as you would recall, made substantial changes to their impairments and toxic losses during 2008. And then if you look at the first six months of the year, and what's driven some of the profit, it's largely been to some extent a tapering of losses, but to a great extent also benefits from the proprietary trading activity, given the volatility in the marketplace. So I think there's a tremendous amount of cautious optimism that the market is in fact getting better. The recent data coming out of France, and Germany, and Japan are reassuring to some degree. But I think we're going to need to

see a significant improvement in unemployment. And I agree entirely with Eric. In retail banking, that is in fact one of the leading indicators of credit quality, consumer confidence, and all the things that really drive the economy. I think we're all optimistic and hopeful. We'd like to believe that this has gotten better. I think right now the jury is still out on whether this is sustained or whether this is a near-term improvement compared to a very, very poor year, which was 2008.

Mike: You mentioned toxic losses there. If I can come back to you, Eric. Certain banks have escaped relatively unscathed, but others are still struggling. Were the various toxic asset protection schemes a help or a hindrance?

Eric: Well, I think you only have to look at the take-up to see how they have been used proactively by a number of banks. I think that strategic decisions need to be taken as a component of a strategy to manage out of what was a credit crisis preceding a recession. They've been very useful indeed. I think one of the questions that we need to look at as we emerge from the darker days of 2008 is, "what happens when a number of the liquidity and asset protection programs start to run off? How are banks expected to continue to trade their daybooks? How are their balance sheets expected to continue to replenish?" That suggests to me that around 2011 there could potentially be a rather unhappy coincidence of peaks in unemployment, of increasing base rate, of increasing regulatory demands for liquidity and capital requirements. At the same time, some of the instruments that have been used to improve and repair balance sheets might actually be withdrawn from the table. So I think there's still quite a complex and rather difficult path to negotiate to get us through the next couple of years.

Mike: Talking about the instruments that have been used to improve balance sheets, have they been working to the extent that they should have been?

Eric: Well, I think we would see that yes, they have. I think that what we would see is that we would be keen to understand how those could be continued and allowed to run off in a measured way over time rather of truncated. Those are discussions for the future. I think one of the more immediate concerns that certainly has been voiced in public pronouncements is the Bank of England's Quantitative Easing Program where banks have used the money introduced to the system to build balance sheets in the first instance. It will be interesting to see how that plays out, as we appear to be moving back to considerations of an inflationary economy, rather than deflationary. So that all needs to be worked through as well.

Mike: You're looking thoughtful there, Vikram. What are your thoughts on that?

Vic: I think if you look not only at what the government has done here but around the world, I think there's been a concerted effort to jump-start the system again, to get liquidity back in the marketplace, to keep the machine running, if you will. I think you're seeing a positive response coming from different parts of the world around this. Different countries will take a different amount of time before we start to see the true benefits of this. I agree with most of the points that Eric made. I think the industry is very polarized though. I think the banks are still wrestling with the historic margins that they have delivered. And the businesses continue to run under those historical margins. I don't think

this industry can return to the margins prior to 2006. There's a lot of deleveraging of balance sheets occurring. There are going to be increased requirements of capital for different variations of risk. I do believe that this industry is going to reset itself. And I think until there's broad acceptance that we have, in fact, reset the income statement to a more normalized margin, I think this industry will stay polarized. And I think you will see those economies that accept it, you will see the benefits of the various government schemes kick in a lot sooner.

But I think when you have this infusion of various programs from the government and an industry that is still retaining a historical context to the way it makes money, I think that's what is going to cause some friction on the table. And the other element is, we are now seeing a significant amount of public scrutiny and transparency in the system. The covers have come off, and there's a lot of discussion going on right now about things that historically we would never even know of. In my personal view, I do believe the industry will reset to a more normalized profit level.

Mike: OK. Anything you'd like to add to this topic, Eric, before we move on to the area of consumer confidence?

Eric: I think what I would probably add is a degree of granularity around the course of retail banking, where margins are so much thinner, where there comes a point in a low base-rate environment where the tensions between an appropriate return for savers and the market-led price for borrowing means that there is only so much interest income that can be generated. Whereas, of course, for the major banking groups, there is a significant infrastructure cost that needs to be met. So in the context of retail banking, the lesson, that is "move away from the historical profit context into a new world where different income streams need to be found", is something that is very much towards the top of the agenda. I think there are also complications to the extent that product services are being subjected to increasing regulatory scrutiny, and actually the design of products is being regulated into the marketplace as well, which means that the innovation or the capacity for innovation potentially is being limited on two counts. One: because the model is being more and more prescribed, and two: because of this regulatory change, the opportunity cost is that innovation isn't allowed to breed in organizations, as organizations are busy making sure that they are compliant.

Mike: Is there room for innovation in how to be more compliant?

Vic: Innovation in my mind is recession-proof. I think this industry has relied on complexity as a basis for innovation. Case in point, a lot of industries like the software industry or the electronics industry has patent protection. You can build something, you can record a patent, and you are protected for a duration of time. In the financial services industry, and this is more a comment about the capital markets as opposed to retail banking, the innovation was driven around the complexity of the product. The more complex the product, the less likely that the bank across the street can create the same thing, or it might take them longer to do it. Now that complexity has unfolded and we've seen obviously the outcome of that level of complexity. I think this industry will return, or needs to return, to some fundamental levels of innovation. If you look at retail banking

over the last thirty years, there has been very little innovation. There have been variations in products, there has been fine-tuning of products, but we have not seen the development of a lot of new products. Now we are seeing innovation around the world. There are banks that are innovating. Interestingly enough, the innovation is happening in markets that one would never think of, in countries in Africa, in Southeast Asia, in Turkey.

Going back to the compliance end of it, I hope there's not too much innovation in compliance because that could get us back to the same situation. I do think that it is going to require greater levels of transparency within the enterprise. A lot of banks will struggle to comply with the host of regulations, not because of a lack of desire, but because of an operational environment that is so complex, it makes it really hard to get to the innovation. So I actually think the real innovation is going to be simplification of the operational and business model. We've made this business more complex than it needs to be.

Mike: Moving on to the issue of consumer confidence. Depending on who you talk to, obviously some people have a lot less confidence in the banks and the banking industry in general now, others maybe not so much. But I think by any account, there is probably less trust in the banks now than there was. Would you agree with that, Eric? And if so, what should the industry do to combat that?

Eric: Where we sit, I think we see the consumer satisfaction surveys, and the analogy I typically draw is akin to the National Health Service, where in general terms, if the public are asked about their views of the health service per se, the levels of confidence are quite low, satisfaction levels aren't particularly inspiring. However, if you were then to probe and ask about the local hospital, that tends to get a higher level of satisfaction rating, through to the individual's GP, and when you move into a specialist, such as the physio- or similar, that again improves the satisfaction rating. So playing that out against retail banking, satisfaction levels around banks in general are not high. Levels of trust equally, I would argue, aren't too high either. However, when you move through to relationship management, and that can be implicit in for example, a village branch as opposed to a busy town center branch, the satisfaction levels rise to very high levels indeed. And when you get into relationship management around wealth management portfolios, high net-worth individuals, and to an extent also still around small business and corporate business relationship management, satisfaction levels are very high indeed.

The question, I suppose, that we really need to debate is, whilst there is a satisfaction perhaps born of the day-to-day, things don't go wrong, the money goes in and out, what about the trust that would encourage individuals to make longer-term savings and investment decisions? And in that context, I suppose, the open question is, would a consumer look first to their bank, or would they compare the market in a broader sense? Ten years ago, I think the answer would have been, levels of satisfaction and trust would be such that the bank would be front of mind, first port of call. Now I think the banks have quite some work to do to make sure that they retain that position.

Mike: Vic, you talk to a lot of banks and other organizations within the financial services industry. What's your take on the issue of trust and consumer confidence?

Vic: I think it has been severely impacted. For example, most banks have historically used size, ubiquity, and scale as a proxy for trust. And so consumers would say if the bank is big, if I recognize the fact that they have locations all over the place, there is a bank of a certain size, they must be safe. That's always been a proxy for that level of safety. And the past year-and-a-half has proved that that's really not necessarily the case, evidenced by some fairly significant failures, for example, out of the U.S. There was a significant amount of trust in the system 20 years ago. And as this business got bigger and it got more impersonal, I think that gradually eroded, and the events of the last 18 months, I think, have eroded trust in the system even further. Eric, you made a point about the wealth management and private banking. For example, in Switzerland, the large private banks have seen a mass exodus of assets under management, even though these are banks of a significant size, and then there is a steady outflow of money; some of it driven by regulation, some of it driven by just sentiment around does Switzerland still have the same level of protectionism it typically had?

I think this industry is going to have to work very hard to regain the trust and confidence of their customers. And I'll replay for you what a client told me once when I started my career in banking 25 years ago, and he said, "Trust cannot be sold, it must be demonstrated." So this is beyond marketing; it's beyond a brand. It really is what do you do within the branch or the call center; how are you serving these customers, do you know these customers? And if you look at the U.S. as an example, where in some markets, one in 10, one and 15, or one in 20 houses have been foreclosed. I mean, there's a significant change to the lives of these individuals and small businesses. So I think time will tell.

But also right now, the industry has relied on the fact that there aren't a lot of options. No one is perceived to be fundamentally different or fundamentally better. So if you draw the same analogy to healthcare, there is one system, and so you base your judgment based on the system you have. And I think the moment you have a competitive shift in the banking landscape here, and someone does offer a fundamentally different value proposition, then people with experience can see the art of the possible, and I think things will change.

Mike: Well, we'll come on to competition in a moment. But I'd just like to get back to you, Eric. Could maybe one of the problems be that the banks and financial services firms are not aware of the level of trust that has been lost over this last 12, 18 months or so? Is that a fair statement or question?

Eric: I would say that a very harsh lesson has been learned that the banks, to the points made earlier, the banks have had to adjust to what they had taken for granted. I think that certainly, the intellectual thought that engages the CEOs and the senior management teams just now is "how do we get to the right sort of value proposition that encourages people to buy into our brand?" Actually, the point is very well made. This isn't about having the slickest advertising, this isn't about having the right look and feel, this is about something far more intangible, and it's about getting back to the respect and the integrity. And that is, I think, where by regaining that integrity, where the long-run, remunerative, win-win type customer relationships will emerge.

Mike: Fair enough. Vic, I'd like to address the next one to you because you brought up the topic of competition in your answer to the last question. Where do you see the new competition coming from in the banking industry? I mean, obviously, the industry is changing. But how much is it changing and where will these new entrants come from to challenge the big retail banks?

Vic: You will start to see other brands that resonate with consumers; be it supermarkets, be it electronics, appliance manufacturers who have a certain presence with consumers, start to leverage that presence significantly beyond what they do today. I think the UK is in dire need of increased competition in retail banking. We have a lot of concentration in this marketplace, and that does not foster a strong degree of innovation and new value propositions and service. So I think you will start to see, and we've already seen the beginnings of supermarkets who have really embraced the financial services landscape in the UK. I was reading in the paper today that Tesco Personal Finance is going to hire 800 people in Scotland. In a market where banks are shedding, here you have one that's going to expand and grow. We will probably see a lot more of that. We might actually even see when the market stabilizes in the UK, some foreign entrants, the traditional banks that decide to revisit this marketplace as one they want to play in.

The one that I particularly would watch for are actually the ones that don't make our radar screen today, the people who make devices that we carry in our pockets that are very capable of doing a lot of things. I don't know about any of you, but the last time I walked into the bank branch was probably 15 years ago, and I tend to do everything remotely. We've been talking about this for a while, but it'd be really interesting to see some of the consumer electronics companies. If they can get a consumer to upgrade a 200-pound or a 300-pound phone every 18 months, they figured out something that the banks wish they had.

Mike: Also, if they've got all of the technology that they need --

Vic: It's ubiquitous, and that's the whole thing. And we are getting more interconnected; our devices tend to talk to each other. The interconnectedness of these devices has a profound impact on banking. It has a profound impact just like the Internet did on person-to-person payments. And the reality is PayPal captured that market very effectively. But now, what happens when all our devices are interconnected and smart systems around traffic, around healthcare, and you know have level of payment interaction between consumers that we've never anticipated; this is not very far away.

Mike: Are the traditional banks worried about this, Eric?

Eric: Well, I think to address the last point first, Vic is absolutely right to identify emerging technologies as a way of introducing competition into the market. I think from a personal perspective, I find it very invigorating. I think it's particularly exciting, and I think that in the context of as we discussed earlier, introducing levels of trust and integrity, the use of technology in an intangible way could see the industry looked at in a whole different light. So in a broad sense, I think that's something that really should be motivating the industry to get out of bed in the morning. However, competing around those technologies would not necessarily be just the preserve of perhaps the Telcos or the

device providers. There's nothing to stop JVs in existing incumbents from looking to use that potential competitive advantage. Going back to levels of competition in the market, I think we've always felt that competition is a good thing, of course, within the right parameters. The likes of the supermarket banks breaking away from the strategic partnerships with existing major banking groups, I think, is one dimension to an increasingly competitive environment.

Acquisition strategies, as we've seen with, for example, Santander and perhaps other banks looking to buy into the market, is another component of that competition. Divestment that banks of course might be considering will create certain opportunities, and that of course will introduce in turn its own vibrancy. But also I think that banks and other institutions will be looking to compete around different types of offerings, so a differentiation between and within portfolios. Some of that might be a service-led proposition, some of that might be a distinct portfolio such as a business-led proposition, etc. All these, I think, are, if not in the mix, on the cusp of being thrown in. And I think that we will see a very competitive market that will be wholly different in five, ten years time to the market that we've seen, which has to an extent moved on from the Big Four dominance of days gone by.

Mike: You touched on differentiation factors there. So to wrap up the discussion, looking ahead to 2010 and beyond, what will differentiate a successful bank going forward from here?

Eric: I think the way I probably answer that is to say, "What do I really want?" Because for many years now, I've been arguing that, whereas previously banking was a traditionalist, conservative, supply-led product, I think what I would like to see is very much a move to a demand-led service. So I want to, and very much to Vic's point, I want to be able to get up in the morning, remember that I need to send my goddaughter a sum of money for her birthday. That I can do using a handheld device at my convenience, when I'm waiting for a train or on my journey to work, that at the same time I can use to arrange my financial affairs, that maybe becomes more interactive in the context of reviewing and considering investment or credit products that I might want to take advantage of, all wrapped up with an immediacy that will only come through the application of ever greater refinement in technologies. That's sort of what I'd like to see. Will we get there by 2010, 2011? I think we need to be realistic. There's probably going to be a longer term before we get to those sort of outcomes. But if I was to be able to access that sort of functionality, have that sort of interactivity, the connectivity that's already been mentioned, then I would start to think, "You know, I trust this kind of relationship. I have a lot of confidence in it. It gives me as a consumer a high level of satisfaction." That starts to put us back to, perhaps, where we would like to be. So as I say, the excitement in all this for me comes down to the application of those technologies. Can we do that in a couple of years? I think that's a little too ambitious. Can we get there perhaps in five, ten? I think that's very much part of the forward agenda.

Mike: Vic?

Vic: I agree that it's going to take this industry time to transform, but I think there are fundamental decisions that banks will have to make sooner as opposed to later. And I think that, to answer your question, you have to separate the discussion into the discrete pieces that comprise our large banks today. So there's the retail banking side, and obviously the commercial and capital market side. And I think there's a different level of competitiveness and differentiation for each one of these. But let's focus the conversation on retail, which is where we've spent most of our time today. I think this industry will have to return to its origins as it relates to customers. There was a time when branch managers knew the customers. There was a time when being a branch manager was a respected job. It was something that was viewed as an important element of a local community. That has been lost over time because the banks have gotten bigger, larger, and more complex. I think a lot of banks right now need to revisit their business model to say, "How do we simplify?" This is really a matter, not necessarily of new technology, this is all about simplification and an underlying management system that enables a level of consumer trust within most banks.

I think there is a future state that naturally follows when you have that level of trust and confidence of your consumers. As you deploy newer technologies, as things advance, the uptake of this is significantly faster. The Internet was a classic example. It took the Internet, I believe, less than five years to reach the same uptake as it did, I think, twenty years of ATMs. And what's next? I think the element of consumer confidence is going to be a major basis of differentiation for a bank that figures out how to do it. How do you do it when you have a hundred thousand customers, a million customers, or a hundred million customers? Time will tell, if the industry gets there. And maybe I just have a bias towards this. I think the industry does need to get there. And then the competitiveness is all around innovation, around convenience as opposed to size and ubiquity.

Mike: Any final thoughts, Eric?

Eric: I think I've got plenty of final thoughts. Whether they would stay within the bounds of what we're looking to discuss... I suppose for me, if we were to summarize the key take-outs from the discussions, there is a job of work to be done to perhaps restore a level of trust. I think that's acknowledged within the industry. There has been a severe wake-up call in the form of the credit crunch. We approach this discussion with no insignificant amount of contrition. There are some very difficult economic times ahead in the context of a recession. However, ending on a more positive note, I think that there are very exciting opportunities that will be driven as a function of competition through the application of new technologies. And what I would like to think is, we would get to a period of enlightenment that would see us into a far more comfortable relationship with our customer base in the years ahead.

Mike: Well, thank you very much for those thoughts, Eric. And thank you, Vic, for joining us. It's been a very enlightening discussion.