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For decision-makers
in financial services
April 2013
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From the Editorial team

It is difficult to form a clear judgment at the moment about the state of economic performance and its impact on the financial services industry. Every month, statistics are scanned for signs of consistent trends; but the picture remains confused. Recovery in one place is offset by further gloom elsewhere – and is itself reversed a month later. Perhaps the 'new normal' which everyone is seeking to define will simply be characterized by continuing uncertainty and unpredictability.

Financial services firms therefore face a twin challenge. They need to develop new business models for the new, post-crisis environment; but it remains unclear exactly what this environment will look like. At the same time, though, they have to rebuild turnover and profitability, and deal with the increasingly demanding – and sometimes inconsistent – new regulatory measures being imposed on them. A focus on the short-to-medium term is understandable, but it is producing mixed results; efforts to reduce costs and improve capital efficiency are failing to feed through to higher profits because of low interest rates and higher regulatory demands.

The articles in this issue of *frontiers in finance* reflect a number of aspects of this search for growth in difficult times. Jeremy Anderson's keynote article addresses this challenge directly. And in our latest regulatory round table, the heads of KPMG's Regulatory Centers of Excellence express concern about inconsistent and sometimes contradictory progress.

In the banking sector, the search for a profitable new strategy raises the question of whether banks have fully understood the extent to which the environment is changing, and whether they have the ability to respond. Attention is increasingly focused on Asia as a market for sustainable growth, but there are challenges here too. China, in particular, is suffering serious inflation, and the government's actions to damp down demand are squeezing the supply of credit.

In insurance, new technologies – such as data analytics – and new markets – like micro-insurance – offer more promising prospects. But the current operating environment is too often still characterized by low growth, flat yield curves and increasing demands from external stakeholders. We look at aspects of all these issues, as well as: the challenges facing private banking; how investment banks are struggling to respond to the new situation; and the controversial, but often misunderstood, topic of high-frequency trading.

Trust in the financial services sector has taken a further hit, reflecting increased dissatisfaction, not only over performance but also over behavior. The conduct agenda is attracting increased attention from regulators in a number of jurisdictions. But trust cannot be rebuild by regulatory fiat. It has to be earned back by consistently excellent performance. KPMG continues to be part of the debate and is committed to working with financial services companies, regulators and industry bodies to help restore trust. The articles in this issue illuminate how challenging this is going to prove.

Giles Williams
KPMG in the UK

Jim Suglia
KPMG in the US

Andrew Dickinson
KPMG in Australia

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KPMG's Global Financial Services Chairman discusses three things financial institutions need to do to grow.

Growth in difficult times

Jeremy Anderson
Global Financial Services Chairman

The financial services industry has a particularly intimate relationship with the wider global economy. Financial businesses are subject to the same broad trends in economic growth and performance as other companies. At the same time, though, finance plays an indispensable role in enabling, underpinning and promoting wider economic activity. This role places financial services in a pivotal position as the world continues to struggle in the aftermath of the crisis.

Davos

This year's meeting of the World Economic Forum in Davos strikingly revealed the nature of the challenges facing us. Christine Lagarde, Managing Director of the International Monetary Fund, said that the economic climate was much better this year than last year, and forecast that the global economy would grow by 3.5 percent during 2013. However, she described the recovery as "fragile and timid", in part because the Eurozone is prone to political crisis and slow decision-making processes. Mark Carney, Governor of the Bank of Canada and soon to take over at the Bank of England, warned "There are still tail risks out there… While central bank action is crucial; this needs to be reinforced at the national level on the fiscal and structural sides: neither of those agendas are anywhere [near] being finished."[1]

Against this background, the conference took as its theme *Resilient Dynamism*, with events being organized under three thematic pillars: Leading Through Adversity; Restoring Economic Dynamism; and Strengthening Societal Resilience. In all cases, neither resilience nor dynamism alone is sufficient. In the post-crisis world, resilience must be a goal for all countries if they are to endure another significant downturn. Achieving dynamism also has to be a priority now that crisis response has given way to the implementation of restructuring programs.[2]

Growing in hard times

The twin challenges for financial services firms, then, are to develop their own resilient dynamism; and by doing so to help create the conditions in which the wider global economy can do the same. Above all, this now requires a focus on sustainable and soundly-based growth. There is no simple route to earning the right to growth in hard times. When business grows as a result of the rising tide of economic expansion, it is easier. Today it is different.

It is a few years since the back-to-basics phrase was on everybody's lips. But it is still relevant. Achieving growth will come from the fundamental strategies: selling more

1 The Global Economy in 2013: "Fragile and Timid Recovery", www.weforum.org/news, 26 January 2013
2 Report of the World Economic Forum Annual Meeting 2013

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Jeremy Anderson
Global Financial Services Chairman

products and services – which deliver genuine benefits – to existing customers; developing new offerings; taking both new and existing products and services into new geographies or customer segments.

Restoring profitability means doing all this as efficiently as possible, and driving out surplus operating costs while preserving resources for investment in IT, systems and processes. The companies which are already succeeding in expanding their business are the ones with clear strategic objectives and a strong executive focus on service excellence in all areas.

Changing attitudes to finance and financial services

The discussions at Davos were notable for another theme: there was a consensus that the 'grow-at-all-costs' model is no longer valid in the post-crisis world. Angel Gurría, Secretary-General of the Organisation for Economic Cooperation and Development, set out a vision of growth focused on achieving 'inclusive prosperity': what is required is to create a climate conducive to fairness and inclusion.

There are clear implications for financial services. The financial crisis has gravely damaged trust in the industry among consumers and decision-makers alike. Political leaders and regulators no longer have confidence that the industry will behave in a responsible and ethical manner in the absence of onerous new regulations in both prudential and conduct matters. There is clearly a significant change occurring in attitudes to the role and operation of the financial services sector. It is too soon to tell how profound and sustained this will be. Changing deeply ingrained corporate assumptions and behavior, and doing so consistently in a competitive world, will be a major challenge. But there are likely to be further constraints on meeting the growth challenge over the period to 2020.

Global mega-trends

These specific changes in the environment for financial services are additional to the broad trends in economic growth and performance I referred to earlier. In the course of our study last year of the future of insurance,[3] we adopted the expression 'global mega-trends' to describe four fundamental forces which we see shaping the future. Some of these forces are already transforming the global political and economic outlook, while others have the potential to influence significantly the political and economic outlook in the coming decades. They apply as equally to banking and investment management as they do to insurance. In summary, they are demographics; technology; environment; and social values and ethics (cf panel).

There is, of course, great uncertainty over the speed and depth of change which these forces may create. But our focus on them results not only from their impact on the outlook for the future but from developments we are already observing. It is instructive to reflect on how rapidly such trends have transformed the economic and social landscape in the recent past. The example of technological change is especially dramatic: it took fourteen years to develop 50 million worldwide users of television; the comparable figure for the internet was four years; Facebook achieved 50 million users within nine months. Similarly rapid change can be driven by the other mega-trends. In seven years' time the environment facing financial services companies is likely to be very different indeed.

Parallel demands

The consequence is that succeeding in sustainable growth will not simply be a matter of hard work and concentration on corporate strategy and service excellence. It will depend also on a firm's ability to respond rapidly to change. The challenge is multi-dimensional. Companies need to respond to broad global changes – in regulation or resulting from the mega-trends discussed above – but also to local developments: specific new rules, market developments, changes in customer expectation and so on.

Developing the necessary flexibility and capacity will require further effort: new business models, organizational change, investment in systems and processes. It follows that the best option in most cases will favor simplicity and streamlining, easing the challenge of future change and adaptation. I am convinced that in five to seven years' time, the successful companies will be those which have managed to meet all these demands in parallel.

GLOBAL MEGA-TRENDS FOR INSURERS

Demographics

Growing populations and longer life expectancy create opportunities for insurers but pose important questions about how healthcare and retirement products are best structured and delivered. Meanwhile, continuing urbanization and changing generational attitudes towards insurance products pose challenges and opportunities of their own.

Environment

The combination of natural catastrophes, urbanization and growing wealth are changing the shape of risk for insurers. Economic expansion is driving more resource-intensive consumption and greater resource insecurity, while climate shifts add further challenges.

Technology

Greater connectivity and use of social media provide insurers with access to an unparalleled wealth of data. While cloud computing creates the potential to enhance flexibility and reduce costs, many insurers are constrained by legacy systems.

Social values and ethics

More effective engagement is needed to overcome the erosion of trust as expectations of good governance are changing dramatically. There is a significant opportunity to harness the power of social media to empower stakeholders as ambassadors for responsible business. However divergent social values and economic outcomes mean social unrest remains a threat.

3 The Intelligent Insurer: Creating value from opportunities in a changing world, KPMG, 2012

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In our regular roundtable review of regulatory developments in financial services, Giles Williams, Jim Low and Simon Topping are in a cautious mood.

Regulatory round table:

Giles Williams, KPMG in the UK
Jim Low, KPMG in the US
Simon Topping, KPMG in China

In January this year, political and business leaders from around the globe gathered in Davos for the annual meeting of the World Economic Forum. What was notable this year was that leaders of financial institutions were fundamentally at odds over the issues facing the banking sector and over the direction regulation should take. As the official Davos news release recorded:

> Leaders of the world's largest financial institutions… agreed on the need for regulation, but disagreed on how much is too much and whether or not global regulation is possible in today's rapidly changing, multipolar world.[1]

Min Zhu, deputy managing director of the International Monetary Fund (IMF), commented that the financial services sector is simply too big. Paul Singer, head of Elliott Capital Management, disagreed, saying the sector is "too leveraged and too opaque." Jamie Dimon, chief executive officer of JP Morgan Chase, responded that banks are not too opaque, but they are complex. Global regulation is needed, said Axel A. Weber, chairman of UBS: global banks cannot operate in markets with different regulatory environments. Tidjane Thiam, chief executive officer of Prudential, disagreed: "Global regulatory standards are desirable, but will be difficult to achieve." Dimon commented that five years after the crisis, "we still have not

What was notable this year was that leaders of financial institutions were fundamentally at odds over the issues facing the banking sector and over the direction regulation should take.

1 Bankers call for better – not more – regulation, www.weforum.org/news, 23 January 2013

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Still far from certainty

fixed a lot of things… we are trying to do too much too fast." And so on…

Losing direction, losing impetus
Five years after the financial crisis, these exchanges point to some serious underlying problems in the process of developing a framework for financial market regulation. What began as a united political imperative from the G20 to ensure more robust and stable markets and prevent the risk of future crashes seems to have lost its way. Political leaders seem increasingly at odds. Regulators are struggling. Consensus is giving way to domestic protectionism and international conflict. Many might argue that the measures which are being formulated and introduced have increasingly little relevance to the original intentions.

New regulation is being developed, but slowly. In the United States, some 45 percent of the rules drafted under the massive Dodd-Frank Wall Street Reform and Consumer Protection Act still have to be to be finalized. The consequence is that financial services companies are inhibited from entering new markets, hiring new staff or introducing new products. Fundamental new measures are due to be introduced to regulate over-the-counter (OTC) derivatives, to restrict proprietary trading (the 'Volcker Rule') and to improve corporate governance. But these are all still matters of debate and uncertainty.

Meanwhile, the US government is increasingly seeking to impose its financial market policies on the rest of the world through measures such as the implementation of Title VII of the Dodd-Frank Act (OTC Derivatives) and the Foreign Account Tax Compliance Act (FATCA) at the same time as threatening measures, for example, on branch capitalization, which would protect its own financial industry and disadvantage foreigners. President Barack Obama's stated desire to work together with global regulators seems to have been forgotten or at least the pace by which regulation outside the US is not keeping pace with regulation inside the US. Rational regulatory development is being subordinated to political window-dressing.

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In Europe, deep differences over how to deal with the sovereign debt crisis are creating challenges over proposals for a European banking union, including Deposit Guarantee provisions and the establishment of a European Resolution Authority and this is overshadowing the whole regulatory process. Key reforms designed to tighten controls around OTC derivatives trading (under the European Markets Infrastructure Regulation) faced a challenge after the European Parliament initially rejected proposals formulated by the European Securities and Markets Authority (ESMA).

Formal ratification of the rejection, which would have imposed a formal review of the whole process, was only avoided after intervention by Michel Barnier, EU Commissioner for Internal Market and Services. Nevertheless, the *Financial Times* commented that "The process of setting technical rules applying EU financial services legislation has become increasingly fraught in Brussels, with some MEPs, EU states and industry groups complaining about the power wielded by the commission."[2] While this was resolved, the subsequent debate around CRD4 highlighted the determination of the European Parliament to be taken seriously. This new found confidence looks like being a permanent feature.

Uncertainty and/or delay are the dominant themes in other areas of the regulatory agenda. The investment management sector has finally seen the publication of the Level 2 measures for the Alternative Investment Fund Manager Directive (AIFMD), but there will be a further delay before implementation. The ring-fencing of retail banking activities continues to attract considerable attention in the UK. But the future of the Liikanen Report recommendations on the structure of the European banking industry are still up in the air, thrown into doubt by Barnier's comments that ring-fencing banks' trading activities could damage the European economy which is a similar debate in the US with the Volcker rule.

The wheels continue to turn…

A great deal of detailed and technical activity is proceeding. The Basel Committee on Banking Supervision has published principles designed to strengthen banks' risk data aggregation capabilities and internal risk reporting practices, which are intended to enhance risk management and decision-making processes.[3] The International Organization of Securities Commissions (IOSCO) has published a set of recommendations aimed at ensuring securitization markets develop on a sound and sustainable basis.[4] But it is difficult to escape the sense that there is a lot of shadow-boxing going on with few proposals being finalized.

In Asia, the implications of the Basel capital and liquidity reforms remain at the top of banks' agendas. The issue is complicated by the impact of the systemic risk agenda emanating from Europe and the US, causing concern among host country regulators about their place in the international supervisory 'pecking order' in the event of default. Protection of domestic investors and consumers is becoming more of a priority in some countries.

Several countries in Asia are looking at ways of tying down foreign banks' capital to their own jurisdictions, for example, through mandatory purchases of local financial assets stipulated by the supervisor, as in Indonesia. There is also the possibility, as in Hong Kong, of localized requirements applying to foreign banks that operate in a branch form, as well as to subsidiaries. Such requirements could put an end to intra-group or wholesale funding models. Several banks are either considering or already planning for a more locally-based funding model, while others are weighing the need for a physical presence in the region against the cost of these new requirements.

In some smaller markets, Asian supervisors are working to establish the criteria for designation of domestic systemically important financial institutions (D-SIFIs). Where foreign banks play a significant role, it is likely that most regulators will require banks to produce a localized recovery and resolution plan (RRP). Where a bank also has to produce a global or home country RRP, ensuring consistency will be a challenge.

Local regulators are also focusing closer scrutiny on outsourcing of foreign banks' operations and processes. They are looking to ensure that they can assume control in the event of crisis and access the systems and data of the local operations. Several regulators have already commenced reviews of outsourced functions and processes and some (e.g. China) are requiring foreign banks to keep their outsourcing within the jurisdiction under the supervisor's direct control.

Many of these developments reflect the impact of reforms initiated in Western jurisdictions and some appear superfluous in Asia in view of the strong growth and generally stable economic situation in the region. Nonetheless, they are key drivers of the strategic agenda of foreign banks in Asia. Many banks face increasing challenges in reconciling their home office's global strategy with their host country's local regulatory agenda.

… but the destination is unclear

The greatest uncertainty is around one of the most fundamental issues of all: what do political leaders, regulators and societies at large now want and expect from their financial institutions? Will we see something like business as usual return eventually? Or have attitudes changed so fundamentally that a new settlement between finance and society is necessary? Public and political anger at the financial system in the wake of the crisis seems to be giving way to a new morality in which making money from finance itself seems to be increasingly unacceptable. If this is so, how can advanced Western economies survive? Until these issues are resolved, it is not clear just what regulation should be trying to achieve.

This situation makes it difficult for financial services companies to plan and act rationally. Where the direction of policy is clear, it is important to understand the issues and implications, and where appropriate try to bring constructive criticism to the notice of policymakers and regulators. Some of the broad trends discussed above are unlikely to be reversed: companies need to study the potential impacts on their operating models, and review whether new markets and opportunities may open up.

It is difficult to see how far and how long uncertainty can continue before it becomes self-defeating, causing more damage to markets than new regulation is intended to repair. Regulators and the industry alike are coming to realize that the process has gone off track and has moved far away from its original core purpose. Yet, it appears that nobody knows how to change course. In the meantime, the economies of the developed world are collectively showing, at best, anemic growth, with the real action occurring in Asia. If this seems an overly pessimistic view, it does at least suggest one hopeful conclusion: something will have to change to break the current deadlocks. Let us hope our political leaders find a way to achieve this without triggering a prolonged recession.

2 Further Delays for Clearing Rules, Financial Times, 4 February 2013
3 Principles for effective risk data aggregation and risk reporting, BCBS, January 2013
4 IOSCO, Global Developments in Securitisation Regulation, November 2012

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Western Banks in Asia – what does it take to succeed?

Theron Alldis, KPMG in China
Rupert Chamberlain, KPMG in China
Stuart Robertson, KPMG in Switzerland

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It is rare to find a major international bank which does not wish to expand its presence in the Asian retail, corporate banking and wealth management markets. The portion of the population that remains unbanked, particularly with respect to more sophisticated products, is an obvious major attraction, especially given comparative stagnation in the west. The emergence and growing wealth of the middle classes is another key opportunity. But why do so few western banks manage to achieve their objectives and the desired footprint in Asia? What does it take to succeed?

It is clear that penetration of Asian markets is a key objective for many Western banks in search of opportunities for growth and profits. Almost all the major western banks in 'expansion mode' profess to have an interest in Asia. It is illustrated by the fact that over 200 western banks have operations in Asia's banking hubs of Hong Kong and Singapore. However, it is notable that in many cases such aspirations are not supported by detailed and realistic strategy and plans. And historically, only a handful of western banks have been notably successful in entering Asian markets and gaining a strong foothold.

In most Asian countries, the market share of Western banks is very low, and this has not changed much over the last 5-10 years. Foreign banks' penetration in terms of total banking assets is highest in Hong Kong and Singapore. Elsewhere, penetration has been very limited: China, Philippines and Thailand have the lowest penetration with total assets held by foreign banks of 1.9 percent, 2 percent, and 6 percent respectively. Foreign banks hold of only 1.9 percent of total assets in China is the lowest share amongst major emerging markets, according to the International Monetary Fund.

Why is this? And what do Western banks need to do if they are to make a success of growing in Asia?

Headlines

1. There are over 200 western banks in Hong Kong and Singapore – Western banks have successfully penetrated these markets (particularly in the investment banking and private banking sectors).
2. Outside of Hong Kong and Singapore Western penetration has been low – 1.9 percent of assets held by foreign banks in China compared to 69 percent in Singapore.
3. Half of the major western banks will be challenged by a lack of critical mass and gaining a foothold – banks need to deploy assets of US$100 billion to have critical mass.
4. Western banks need to have focus, either on geography or product – they can lead the market in wealth management as the middle class grows wealthier or investment banking as markets become more sophisticated.
5. Successful banks will adopt a long term commitment to organic growth supplemented by opportunistic acquisitions (e.g. as sub-scale Western banks retreat to home markets).
6. Some developing markets might need their banks to raise capital to support GDP growth – Western banks can have a part to play.

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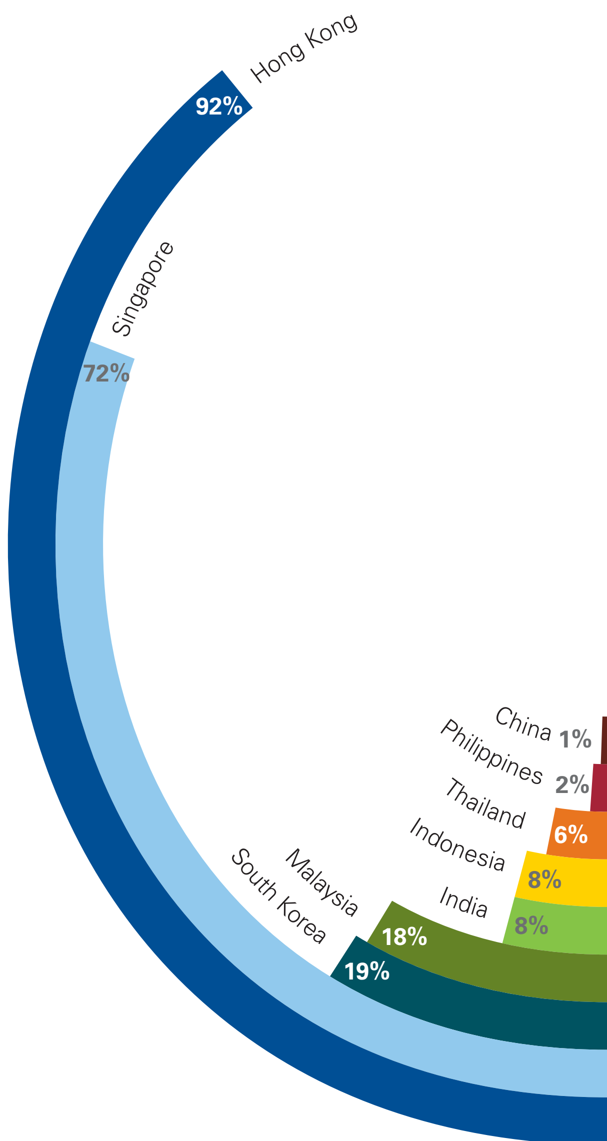
% of foreign banks' penetration by total assets (2009)



Source: IMF working paper, Foreign Banks: Trends, Impact and Financial Stability dated January 2012

Constraints

There are a number of key constraints. The first is regulation. In many markets – China and India for example – foreign owners are limited to minority equity stakes when acquiring existing banks. Many foreign banks who have bought such stakes have not had the level of management influence and strategic cooperation they envisaged. Some Asian countries are even tightening restrictions on foreign ownership: Indonesia, for instance, has introduced stricter limits.

A second constraint is that most domestic markets are dominated by a handful of companies, often state-owned or state-controlled. In India, for example, 7 out of the top 10 largest banks are state-owned, in China the 'big 4' banks too are controlled by the state. The problem is magnified in some Asian countries by geography. Indonesia, for example is a vast country of over 240 million people, spread across an archipelago of over 18,000 islands. Factors such as this impose significant logistical barriers to entry to any Western bank hoping to develop a significant retail branch infrastructure, for example.

A third complex of issues reflects negative sentiment driven from the global financial crisis. Foreign banks reputations and brands have been tarnished by virtue of their historical practices and need for financial support. Of the top 100 banks in Asia, 85 are still local Asian banks and only 15 are Western banks. These banks all have operations in at least ten Asian countries, supported by a high asset and capital base. It is not uncommon to hear local management of Western banks, articulating that the Western head office does not understand local market dynamics or have a compelling, achievable strategy.

There are obvious counter-examples of successful Western banks: HSBC, Citibank and Standard Chartered Bank, for instance. However, their success and size principally reflects the fact that they have all been active in the region for a very long time. There is

Some sub-sectors are becoming over-crowded with so many Western banks wanting to obtain a foothold.

Western banks need to have focus, either on geography or product – they can lead the market in wealth management as the middle class grows wealthier or investment banking as markets become more sophisticated.

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a key lesson to draw from this: developing a significant presence in Asian retail and corporate banking markets is a very long-term process, depending on steady organic growth rather than rapid acquisition of market share and supported by cornerstone acquisitions of key capabilities or platforms as a basis for scaling up.

One final point is that some sub-sectors are becoming overcrowded with so many Western banks wanting to obtain a foothold. However, there is still an expectation gap between buyers and sellers, with Western buyers in particular still finding it difficult to justify paying the large multiples that sellers expect (three times book value and upwards in some cases). There is intense competition for these targets, and Western banks perhaps don't have the flexibility to compete with some other banks.

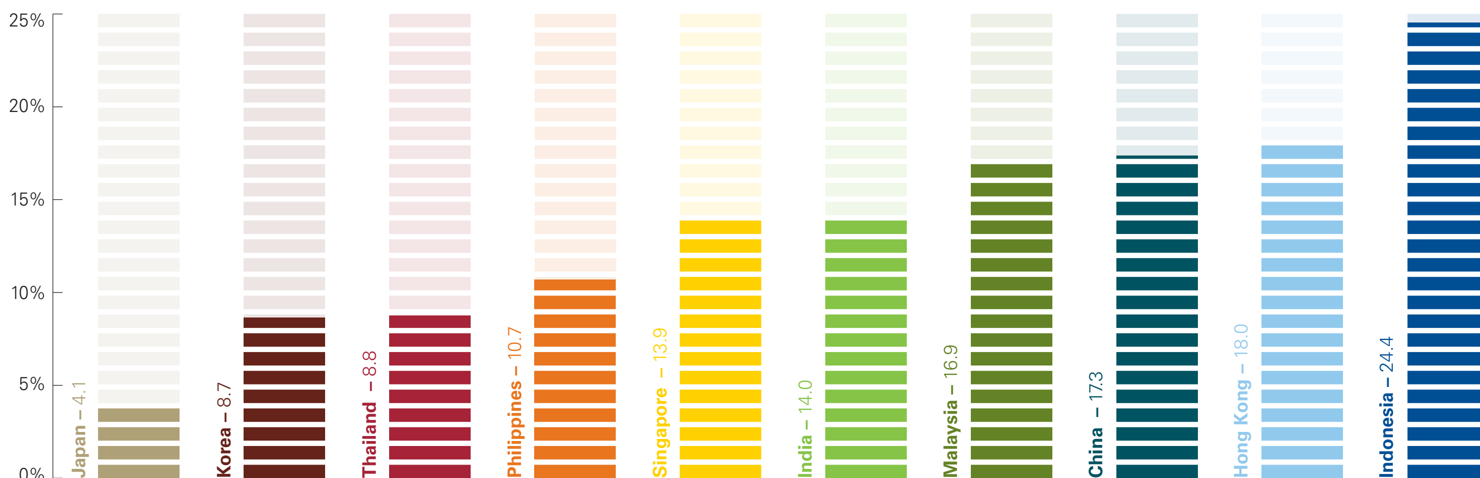
But… major opportunities

The Asian region contains the most dynamic and fastest-growing economies in the world. The Asian banking sector was more profitable than its western counterpart before the economic crisis, and has recovered more rapidly since. In terms of profitability, the average ROE of the Asian region for the period 2007–2012 is 14.6 percent, placing it second globally after Latin America (ROE of 20.0 percent), and far ahead of the US and European banking sectors (ROE of 5.5 percent and 6.8 percent respectively.) Looking at the individual markets, Indonesia promises to be the most attractive in the region, with an average ROE of 24.4 percent for the period 2007–2012, growing young population and increasingly wealthy middle class with a strong appetite for financial products (however tightening regulations over foreign ownership are creating uncertainty as highlighted above). The other most successful economies are Hong Kong, China and Malaysia, offering returns on equity of 18.0 percent, 17.3 percent and 16.9 percent, respectively.

The other side of the logistical challenges is that the size of Asian populations represents a massive potential market. Two factors magnify the attraction. Many markets are under-banked: in many cases, only a minority have bank accounts at all. Second, those who do have bank accounts are largely only using plain-vanilla products and services (i.e. a deposit account and a mortgage or auto loan). However, the Asian middle classes are growing very rapidly. The potential to provide higher added-value products and services, to a higher proportion of growing populations, is an extremely attractive prospect. One example of this is mobile payment services, where Asian banks have been quick to seize the potential and penetration rates are often ahead of their European and US counterparts.

Wealth management, private banking and bancassurance are among the major growth prospects. The number of high–net-worth individuals in Asia has increased by 27 percent in the last five years, and looks set to increase at least as fast in future. It is also a business segment with low capital requirements and high margin potential. In particular, the Swiss banks have built up a strong presence in Asia in the past decades – UBS Wealth Management was named Overall Best Private Bank in Asia in 2010 .[1]

Average ROE % of banking sector in major Asian countries (2007–2012)



Source: IMF website accessed as of February 2013

1 Asiamoney's private banking poll, 2010

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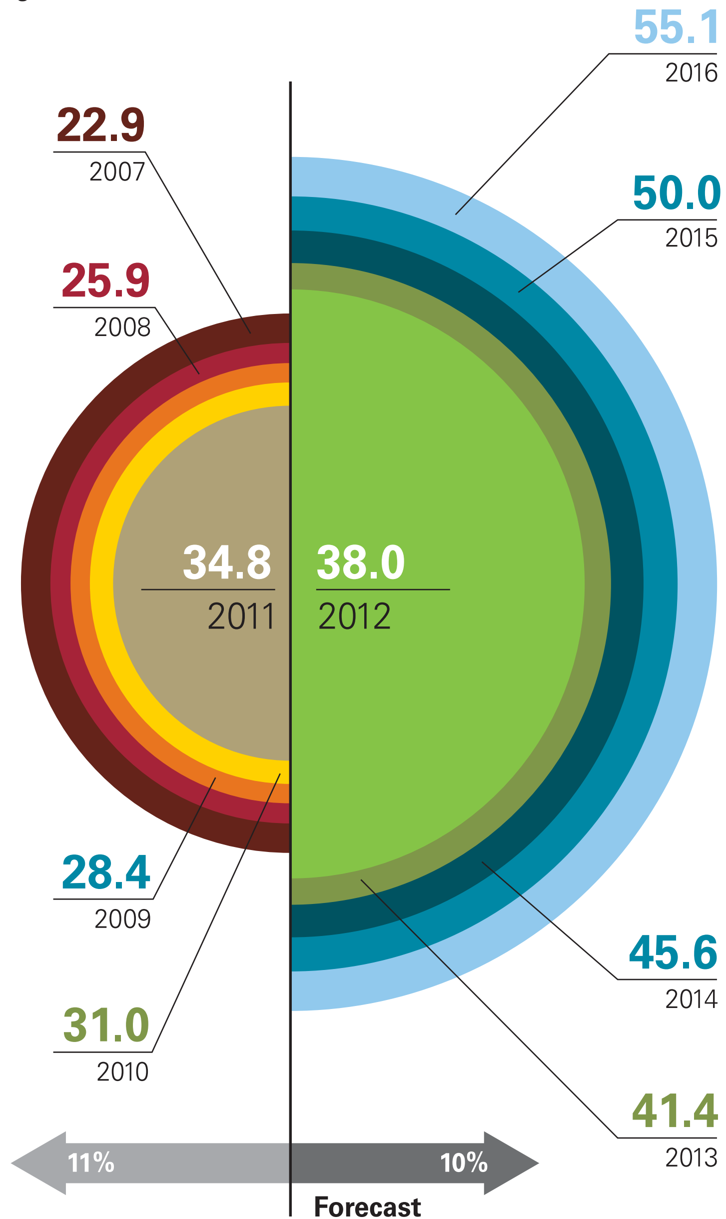
Success factors
Many of the more successful approaches to date have been those which focus on specific geographies, markets or segments and attempt to build out organically from an initial foothold. Additionally many Western banks have focused on serving their home country multi-nationals as they expand in the region.

A further source of opportunities will follow reconfiguring and consolidation in Asian markets. Of the major 70–75 western banks operating in Asia, we believe that at least half will be challenged with critical mass or strategic direction issues and may decide in the end that they cannot succeed in building market presence in the region. Constraints and pressures 'back home' may also play a role. Regulation is becoming more demanding; capital requirements are more onerous; the domestic cash flow and profitability needed to underpin expansion in Asia are becoming harder to sustain. We believe that for a Western bank to become a major player in the region, it needs assets of US$100 billion. Banks which lack comparable resources, and which are suffering domestic constraints and pressures, may focus on a niche role, or pull back from initial footholds, potentially leaving operations behind which can be acquired.

In addition, some banking markets could face additional stress in the near future if domestic banks struggle, for example, to raise capital for Basel III, to fund themselves after years of reliance on interbank debt, or to continue under heavy margin pressure. This could result in M&A opportunities for opportunistic foreign banks. Strategic cooperation with local players, including JVs, could open another range of opportunities, although this is difficult to execute and needs a lot of management attention to be successful.

Despite the variety of influences and constraints, the fundamental fact is that for major Western banks with international scale and global aspirations, expansion in Asia is a necessity. Western banks will go into growth mode again and will seek scalability in Asia thus there really is little alternative but to find a way of penetrating the market.

Asian banking sector



(US$ trillion)

Source: Market Line and Central banks

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The foundations of the capital markets sector are shifting. A range of external pressures is forcing already-stretched operational environments to the breaking point. Leading firms are realizing the growing need to transform their operations to defend their market share and position themselves for the competitive battle ahead.

Rethinking operations: Embracing transformation in a rapidly changing market

Atul Subbiah, KPMG in the US

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Contact
Atul Subbiah

The capital markets environment continues to evolve with unprecedented speed. Complexity is on the rise, even as firms struggle with downward pressure on margins. The industry, still dealing with the fallout from the financial crisis, is struggling to stay abreast of a wave of regulatory change. Revenues from once-lucrative areas such as securities lending have fallen off. Tried and true operating models are exhibiting signs of age and obsolescence. And even as the landscape continues to shift, competition between firms remains fierce.

Firms will cling to the status quo at their peril. The business landscape is strewn with once-dominant companies that chose to dismiss similar warning signs in their respective industries. The financial services sector is no exception. Players of all sizes are rethinking their operating models in response to a wide range of external forces:

- A US-based global investment financial institution recently announced the migration of 30 of its trading venues (which execute, clear and process trades) to a single platform for the first time.
- In a bid to help lower costs for the entire industry, a European-based global financial institution is seeking to forge alliances for the sharing of trading software and tools.
- A US-based global investment bank is embracing the shift to automation, adapting technology and re-imagining its operations as part of a move to become the industry's 'low-cost provider'.

The rules are changing. Against a backdrop of change, pressure and uncertainty, many financial services firms are facing a simple choice: transform or perish.

It's different this time

Organizational transformation is nothing new. The scale of the change facing the industry has been seen before, many times over. What is different this time, however, is the fact that an increasing number of firms are assessing the organizational transformation exercise through the eyes of their customers and in relation to the business model those customers want in the future. This represents a significant shift from the manner in which financial services organizations have tended to approach such transformation exercises in the past.

Preparing for a new operating environment

Increasingly, successful providers will be those that are able to modify their processes in a manner that enables them to optimize customer benefit. Enhancing these processes will, in many instances, influence changes in the overall design of the product portfolio. In this new operating environment, those firms able to offer a differentiated product portfolio, supported by an operational infrastructure that can be easily scaled up or down to mirror market trends and client needs, will be the providers that will dominate, stealing valuable market share from the competition.

This brand of transformation necessarily requires specialization and horizontally-integrated operations, a model that other industries have been following for many years. In these cases, it is common to see dramatic systems-retooling processes, aimed at improving performance and standardizing and simplifying technologies.

Convergence of the competitive kind

An increasing number of financial services firms are looking to consolidate, diversify their product portfolios and enter into new, strategic, technology-focused alliances, both to help gain entry into new markets and as a defensive necessity. For example:

- Investment banks are leveraging operational environments across other parts of their business, such as using their prime brokerage infrastructure to provide clearing, settlement and financing services to their execution clients.
- There is a growing trend, particularly in Europe, toward local custodial, transfer agency and hedge fund servicing businesses consolidating into global or regional groups.
- Outsourcing relationships are increasingly moving toward 'partnership' models, in which two or more firms enter into arrangements with service providers to develop a key product capability with technology as the enabler.
- More central service providers and securities depositories are migrating deeper into the asset servicing business, posing a threat to the dominance of custody banks in certain aspects of core asset servicing.

Achieving the target operating model

Deciding to transform the business model to adapt to market and client needs is the responsibility of the executive leadership team. Based on the particular firm's business strategy and unique market dynamics, the target operating model, which will serve as the cornerstone of the new operating model, should encompass the following guiding principles:

- Operations and technology must be automated, low cost, robust and scalable.
- The operations and technology functions should lend themselves to extension to other parts of the business.
- Traditional geographical delineation of target markets is obsolete. Client needs should be parsed according to developed versus developing markets.
- Redesigned operating models should differentiate between generic and higher margin products in order to leverage scale and low cost with the former and revenue and margin for the latter.
- A joint venture or consortia structure can deliver significant benefits, but is not easy to achieve.

Putting the plan into action

Major transformation programs entail a certain degree of risk. In order to maximize the prospects for long-term success, these complex and wide-reaching exercises must be managed with an eye toward controlling risk. Among the more prevalent threats to success are leadership teams that underestimate the intensity of the effort or the resources required, a lack of clarity regarding the proposed future state and insufficient internal motivation to change.

Leading successful operational change hinges on a clear understanding of the business imperatives and operational requirements, while it simultaneously involves shifting the firm's focus to a strict process improvement agenda. Among other things, putting the transformational plan into action requires the establishing of a set of guiding principles, the identification and addressing of any potential barriers to implementation and an analysis of business impacts, with an eye toward quantifiable benefits.

Leaders need to think differently about their organizations and challenge the status quo in order to effectively reinvent their operations and position themselves for long-term growth and profitability.

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Insurers have always sought to analyze customer metrics. Understanding the potential for loss or damage and the propensity to claim are fundamental to risk management. In recent years, however, modern software, modeling and data analysis techniques have transformed the landscape. The most successful insurers are those who fully exploit these cutting-edge capabilities.

Unlocking the opportunity within: Predictive analytics and modeling in insurance

Mark Bain, Director, KPMG China
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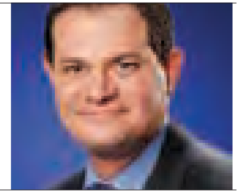

Like many in the financial services sector, insurance companies face a major challenge in generating profitable and sustainable growth, especially in current economic circumstances. However, insurers often face potential costs stretching far into the future. This means that sustainability and profitability depend on identifying the specific characteristics of policyholders that contribute to differential loss potentials as well as developing lasting and deep relationships with clients. Modeling and analysis of customer data are, therefore, fundamental to a successful business model.

Insurers have access to vast amounts of data and associated statistics, particularly historical data on customers, policies, claims, etc. In addition, increasing amounts of collateral information are available on many aspects of customer behavior and experience. This is especially true for insurers owned by banks. Whereas dedicated insurers may have relatively few interactions with customers between an initial sale and a subsequent claim, a parent bank may have access to daily information about a client's lifestyle, behavior and habits. Third-party data sources, such as credit rating agencies and consumer research companies, can also deliver substantial quantities of potentially useful data at comparatively little cost. When this information is properly harvested and analyzed in a responsible and customer-centric manner, it can unlock enormous potential within an insurer's existing and new customer footprint.

The critical issue, therefore, is not the availability of data, but how to analyze it effectively and apply the results to the business.

Data and analysis

Much more sophisticated software has become available in recent years. Deployed hand-in-hand with more powerful computer hardware, this allows companies to routinely undertake analyses that would have been prohibitively time consuming or expensive only a few years ago. Hard figures (e.g. costs, claims, dates, times and other customer details) can be trawled automatically to extract significant correlations that can yield valuable insights into core business parameters.

In addition, dramatic developments in the analysis of unstructured data, or text mining, can allow large volumes of text-based material held in-house to be scanned to extract potentially significant information. Furthermore, publicly available material can complement existing consumer behavior data. Internet technology and social media now allow customers and potential customers to chronicle their lifestyles and consumer experiences online. Many people also use social media networks to evaluate products, services and providers. It is well known that certain key life events, such as buying a house, having a baby or retiring, are associated with insurance purchases. Increasing numbers of analysts and modelers are experienced in the necessary actuarial and statistical analysis. Identifying these key life events can make targeted marketing much more effective.

The critical issue, therefore, is not the availability of data, but how to analyze it effectively and apply the results to the business.

Value

The key benefit of these new capabilities is that they can improve the success rate of prediction. This applies not simply to the probability of an eventual claim, but by extension to all other stages in the business cycle, including targeted marketing, customer segmentation, policy risk profiling and fraud detection. Predictive analytics allows insurers to understand their customers in new and deeper ways, both in aggregate and as individuals or members of more closely-defined segments. Personalized and tailored, this can be developed to satisfy client needs in deeper and a more meaningful way. While this type of analysis was once typically the domain of large personal line (consumer) insurers, the changes we are concerned with enable these techniques to apply equally to commercial, specialty, life and health insurance.

Finer and more discriminating customer and claim segmentation brings additional benefits to many aspects of insurers' business processes. For example:

- Actuaries are better able to estimate future costs and determine premium rates more accurately, yielding improved profitability.
- Claims handling can be simplified by focusing detailed scrutiny on claim sectors with higher fraud propensity or other special handling needs.
- Operating costs can be reduced as processes are simplified and streamlined.
- Many of these benefits will flow to customers, resulting in lower premiums, improved performance and increased customer satisfaction.

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Predictive analytics also supports the development of complementary perspectives on the business. Where insurers have typically focused on risk, its quantification and management, effective modeling and prediction can facilitate a more customer-focused approach. And it is clear that the more that is known about customers, their needs, behaviors and predilections, the easier it is to deepen an insurer's relationship with his or her customers and sell more products to them over a longer period.

A similar approach can be applied to improving distribution channels. Predictive analytics can help attract and retain the right sales and marketing people as well as the most effective distribution partners. By casting light on how much value particular individuals or channels are actually generating, it allows for the fine-tuning of rewards and incentives or, alternatively, helps identify undesirable behavior.

Benefits to customers

As we have seen, the benefits of advanced data analysis and prediction do not all flow one way. Many aspects that create advantages for the company also improve the customer experience.

- streamlined, automated settlement processes for uncontroversial claims with fewer queries, interventions and delays, leading to faster, hassle-free settlement
- policies (terms, exceptions, excesses) tailored to individual circumstances
- premiums more closely related to actual risk, resulting in benefits to lower-risk customers
- faster, more personalized service at every stage of customer interaction.

Overall, the new science and technology of predictive analytics can deliver the Holy Grail of reduced costs, enhanced profitability and improved customer experience.

No magic wand

Predictive analytics is no miracle solution. The benefits outlined cannot be delivered automatically, as if by magic. There are also many potential pitfalls associated with the use of this powerful business tool. Ensuring the validity of analytical results is critical. Spurious correlations, or correlations without causal connections, can be found in any data source. The growing power of analytical software and the apparent richness of unstructured data can lead to overfitting data and increase the chances of false or misleading conclusions. The key point is that data, modeling and analysis are only part of the story. They have to be balanced and informed by a deep understanding of the business. In this respect, the effective deployment of predictive analytics and modeling is an art as much as a science.

In particular, this argument illuminates the specific value of in-house data. Access to the firm's own structured data is the key to identifying genuine business value as opposed to random correlations. Coupled with a thorough understanding of the business model and a strong 'feel' for what is significant in the business, effective analysis can hone in on conclusions of real significance.

Investment

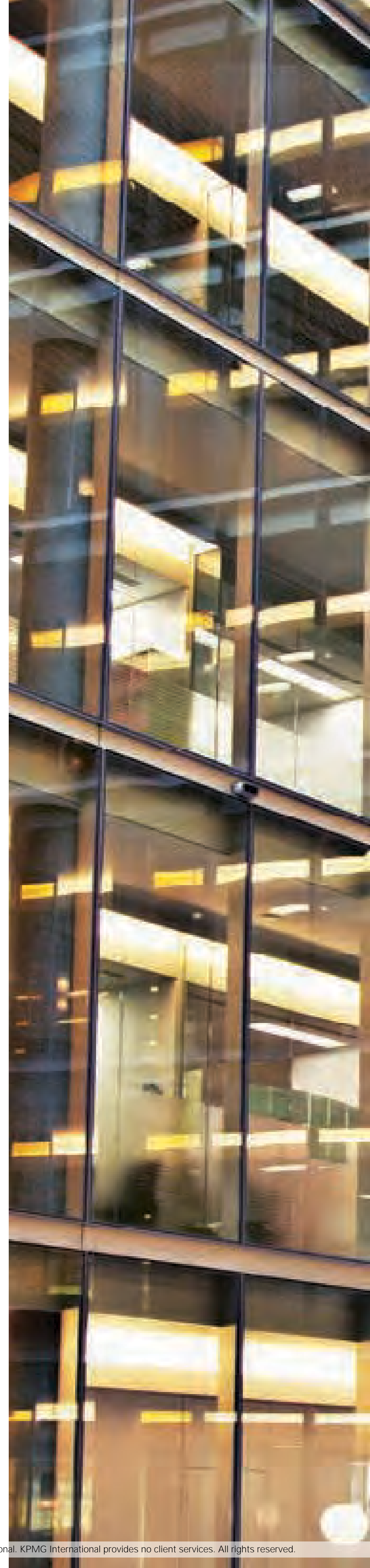
Developing these new analytical capabilities should not be undertaken lightly. Typically, significant investment is needed in hardware, software, collecting, collating and verifying data, in data cleansing and the development of data warehouses. Embedding data analytics in the heart of the operating model as a routine and continuing dimension of management decision-making can require major change. However, many companies will already have a number of key components in terms of hardware and capacity to host the infrastructure and existing analytical tools.

Investments made can have high returns. However, all insurance businesses are different in terms of their business model, risk appetite, target customer segments, product profile, etc. There is no formula that can be applied indiscriminately and no one-size-fits-all solution. It is important to strike the right balance: not overly academic or technocratic, but sufficiently informed by judgment and understanding to yield genuine business insights of identifiable value. In KPMG's experience, it is wise to be wary of 'black box' solutions. The better route is to develop in-house capabilities progressively, piloting proof of concept while increasing scale and capability.

The challenge is to relate the investment to the return in a transparent way in order to evaluate the relevance and significance of modeling outputs. This is especially challenging in view of the very long lead times in the insurance business model. Securing corporate support at the senior executive level for business investments based on data analysis depends on getting buy-in to its relevance and significance in this way.

Conclusion

Predictive analytics and modeling will play an increasingly valuable part in insurers' business models and operating processes. Sophisticated judgment and effective investment can deliver fundamental and lasting benefits to the most advanced companies. In fact, we believe that without strong technical and human capital capabilities to collate and synthesize the massive amounts of data available, insurers will find themselves, at a minimum, potentially missing an opportunity and, at worst, at a serious competitive disadvantage in the very near future.



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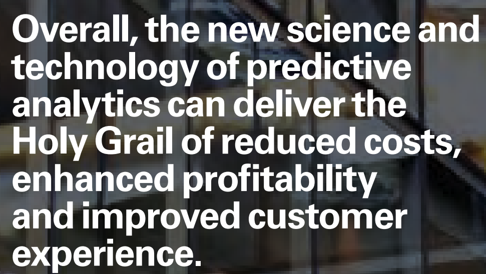

Overall, the new science and technology of predictive analytics can deliver the Holy Grail of reduced costs, enhanced profitability and improved customer experience.

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Holistic approach vital as banks deal with change

Andrew Dickinson, KPMG in Australia
Judd Caplain, KPMG in the US

From regulation to customer behavior, external challenges are driving significant change in the banking sector. As banks adapt their products, business models and corporate cultures, Andrew Dickinson and Judd Caplain explore why it is vital they adopt an integrated, holistic approach.

Banks are facing profound structural changes to cope with regulatory and market developments that are driving down traditional revenues and driving up capital requirements and costs. In this brave new world, 'business as usual' is not an option.

Dodd-Frank's Durbin amendment on debit card interchange fees and proposed changes to Regulation E giving new protections for consumers who send remittance transfers to designated recipients in foreign countries are estimated to have removed US$25 billion alone in potential revenues from the country's banks. On top of this, the Volcker Rule has significantly reduced proprietary trading and further eroded revenues significantly.

In many markets, demand for commercial lending is low and consumers are deleveraging. In addition, net interest margins are at or near historic lows. On top of all this, Tier 1 capital requirements have increased aggressively – particularly for 'systemically important financial institutions' – as Basel II has become Basel 2.5 and then Basel III.

Meanwhile, the regulatory burden is also driving up costs. On one hand, banks have to pay significant fines to address past issues, from payment protection insurance and LIBOR rate fixing in the UK to money laundering and improperly foreclosing on homeowners in the US. On the other, banks have to invest heavily in people, systems and controls to ensure compliance with the deluge of new regulations.

To deal with these challenges, underlying cost bases have to be reduced, which means addressing the structure of the business model and, in particular, the ways in which the bank goes to market. One of the keys to increasing

Huge infrastructures with multiple lines of business and branches will need to be streamlined. Geographic consolidation, outsourcing, offshoring, use of lower cost channels and delivery mechanisms will all have to be studied.

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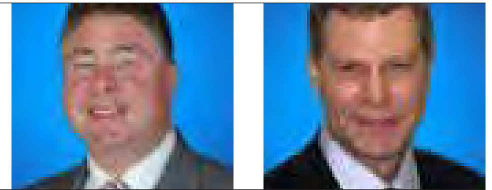

operating model efficiency and end-to-end risk management will be divestment of non-core businesses that are outside the scope of the banks' expertise, do not have the critical mass for growth, or have risk profiles that are too capital intensive. Another will be economies of scale and automation. Inefficiencies in terms of siloed structures that duplicate technology solutions, and staffing can no longer be afforded. Huge infrastructures with multiple lines of business and branches will need to be streamlined. Geographic consolidation, outsourcing, offshoring, use of lower cost channels and delivery mechanisms will all have to be studied.

With banks' return on equity forecasted to decrease to historically low levels, changes to the business model must occur, including integrating the regulatory compliance and cost reduction agendas with the development of new sources of profitable revenue, whether by developing new products, targeting new markets, or repackaging existing products and pricing. Everything is in the mix, from pricing of loans or deposit products to fees and other revenue producing strategies. New models of customer segmentation are required in order to understand better, for example, where transaction fees may be introduced, value-added services linked to monthly fees offered, or mobile solutions to reduce processing costs adopted. These new customer categories might include the use of social media and non-traditional channels, propensity toward self-service, purchase patterns or a preference for certain payment types.

To be able to rationalize product portfolios and optimize revenue, banks need to have a clear idea of each target segment, how these might evolve and the contribution each might make to growth. But for customer preference to shape portfolio composition in this way will require banks to have rich data and dynamic analytical capabilities. Equally, banks will have to become skilled both at developing compelling customer value propositions for these well-defined customer segments and convincing customers of the value of the new packages.

None of this can be achieved without people willing to deliver and work within the new model. Meanwhile, these people, namely bank management and staff, are having to change their behaviors in the face of capital, liquidity and resolution measures that increase the cost of

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risk-taking; structural separation measures that highlight the need for banks to take different approaches to their retail and investment banking activities; governance measures to encourage boards and senior management to focus on risk; remuneration measures to reduce the incentives for inappropriate and excessive risk-taking; and conduct measures that focus on both the design and distribution of financial products and on the incentives for retail customer-facing sales and advice staff.

Importance of an integrated approach

Far from being separate and isolated, regulatory compliance, capital efficiency, revenue growth, cost reduction, business model transformation and culture change are all mutually interdependent. To deal effectively and efficiently with this deluge of interconnected change, it is vital for banks to adopt an integrated, holistic approach at both the process and the strategic level.

For example, many of the new regulations, such as the Foreign Account Tax Compliance Act (FATCA) and emerging regulations around treating customers fairly, affect core business processes, particularly customer processes. Rather than trying to manage this process change in an ad hoc fashion, there is an opportunity to use the need for sustainable compliance with new and emerging regulation as a catalyst for improvements in efficiency, creativity, culture change and customer experience.

This can be best achieved by viewing regulatory change as a portfolio and grouping together these change impacts by process, function and business, thereby eliminating duplication of effort and avoiding unintended consequences. Banks can then change their mind-sets from a focus on doing compliance projects to applying Lean principles to redesign those end-to-end processes most affected by regulation with the aim of not only achieving sustainable compliance, but also maximizing customer value and eliminating waste. By adopting such a portfolio approach, banks can reduce process and systems duplication and complexity over time, align business processes with desired customer experiences and staff behaviors and eliminate activity that does not add customer value.

Strategically, many of the prudential regulatory changes that are happening, such as Basel III, the Dodd-Frank Wall Street Reform and Consumer Protection Act, the Vickers report, the Liikanen report and Recovery and Resolution Planning, affect levels of required capital and liquidity and with it, customer and product profitability and return on equity. They also have profound implications for the organizational structure, operating model and likely competitor actions.

This can be best achieved by viewing regulatory change as a portfolio and grouping together these change impacts by process, function and business, thereby eliminating duplication of effort and avoiding unintended consequences.

Rather than seeking still more regulatory overlays to meet these various requirements, the optimal response will require reviewing and, if necessary, redefining the bank's structure, strategy and operating models. Project and change management will be a core competency as banks assess their current state, decide on their desired future state, plan their future portfolio and execute the change program (see diagram).Going through this process will force banks to answer fundamental questions about the shape of the business going forward: How flexible will product pricing structure and profitability become? What geographic markets do we want to operate in? Which products and services will be viable? Are unidentified opportunities being created? Does our strategy provide the flexibility to deal with the direct and indirect risks and opportunities provided by regulatory change? Is our structure sufficiently simple and agile to optimize financial efficiencies? Most importantly, do we understand the interconnectedness of all the above issues and the impact on our core business processes?

In the new environment of continuous change, the banks that win will not be the ones that are best at doing compliance projects. The winners will be those banks that are best at optimizing their business strategies, operating models and corporate cultures within the context of these new regulatory constraints.

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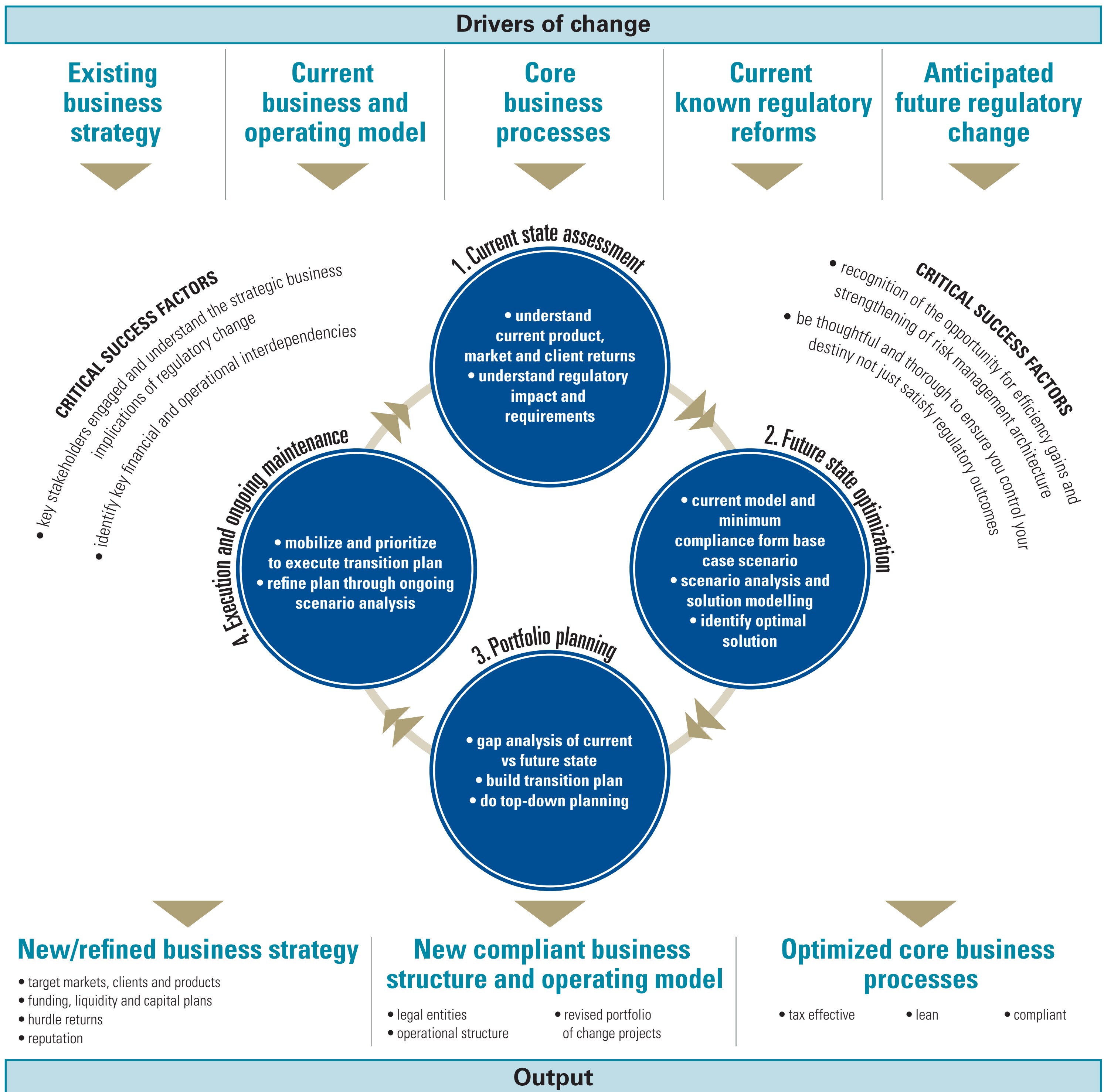
We believe the winning banks will be those that optimize their business strategy and operating model within regulatory constraints.



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The private banking sector used to have a reputation as being rather cozy as well as lucrative. No longer. Multiple developments in the last few years have driven major change. Clients and providers alike now have dramatically different constraints and expectations. The opportunity remains to develop sound, profitable business. But clear strategic decisions are needed.

Pivot, tweak or pounce: Strategic challenges in wealth management

Alain Picquet, KPMG in Luxembourg

Private banking and wealth management have always been attractive business sectors. Wealthy individuals not only have more money, but they also require specialist investment management support, income protection and tax advice for which they are willing to pay a significant price. The numbers of such individuals are growing, despite the financial crisis, both in developed markets and particularly in high-growth emerging markets, such as Asia and Latin America. From the bank's perspective, wealth management carries low credit risk and, as a result, requires lower regulatory capital. A high proportion of revenue comes from recurring fees. With low overheads and limited need for an extensive branch network, this adds up to traditionally profitable business.

Change and challenges

But the wealth management business is changing and will change further in the wake of the crisis and as regulatory changes begin to bite. One significant challenge is that margins are coming under increasing pressure. While assets under management have recovered since the financial crisis in 2008, increases in adviser remuneration and other expenses have resulted in a higher cost-to-income ratio. This trend is being exacerbated by current market conditions, as investors prefer capital preservation products, which generate low fees for the wealth managers.

Investors are also becoming much more demanding of their relationships with wealth managers. In a world where returns are low, assets have suffered losses and trust has been damaged, clients are far less willing to take the performance of wealth managers for granted. They want more vigorous action to generate returns; they want strong frameworks for risk management and wealth protection; and they want transparency and justification over fees and charges. They are increasingly wary of bespoke products and in-house funds; they are looking for portability and low-cost asset classes such as exchange-traded funds. The internet offers them the ability to compare the performance and costs of service providers in an instant.

On the policy and regulatory front, profound changes in attitudes to financial services are still working their way through. The industry is under greater scrutiny and greater pressure to reform itself than ever before. Traditional banking privacy is rapidly being destroyed as banking secrecy in offshore centers and in traditional private banking locations such

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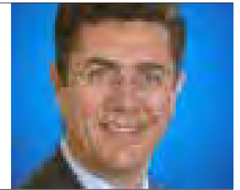
Alain Picquet



The industry is under greater scrutiny and greater pressure to reform itself than ever before. Traditional banking privacy is rapidly being destroyed as banking secrecy in offshore centers and in traditional private banking locations such as Luxembourg and Switzerland is being blown away by a combination of regulatory and fiscal authorities.

as Luxembourg and Switzerland is being blown away by a combination of regulatory and fiscal authorities. The Foreign Account Tax Compliance Act (FATCA) will require effectively full disclosure of all accounts held by US nationals anywhere in the world. Tax authorities are increasingly extracting account information from domestic institutions and passing it over to counterparties in other jurisdictions. Specific regulatory initiatives, such as the Alternative Investment Fund Managers Directive (AIFMD) and the Markets in Financial Instruments Directive (MiFID) II in Europe as well as the complex set of new regulations emerging under the Dodd-Frank Wall Street Reform and Consumer Protection Act in the US are all having serious ripple effects throughout private banking.

These pressures all increase operating costs and require extensive and expensive investment in information technology, systems and processes. The demands of compliance, reporting, more active client account management and other factors can no longer be satisfied with traditional back-office systems and low-technology customer relationship channels.

Strategic options

Wealth management firms that want to survive these increasing pressures and succeed in the new environment have a number of options available. The least radical, but most challenging to accomplish, would be to sustain the existing business model attempt to drive it back to acceptable profitability. This is what we term the 'tweak' strategy. It involves rationalizing unprofitable clients and increasing revenue per client by cross-selling a broader range of services and products. On the operations side, it means ruthlessly streamlining processes and driving up efficiency across the whole front-to-back-office chain. It will be especially challenging to reconcile the costs of necessary investment with improving profitability and to satisfy increasing client demands while streamlining and automating the relationship.

A second approach is to look much more strategically at the future business and regulatory environment and at the longer-term requirements for success in order to reconfigure the business accordingly. We refer to this as a 'pivot' strategy. This may involve disposing of unprofitable businesses or client books; developing and focusing on particular niche products or market sectors where high value can be added; and perhaps changing the geographical target of operations to focus more closely on areas such as Asia, which have the most rapid growth in high-net-worth (HNW) individuals.

Finally, churn in the marketplace is likely to increase and open up other opportunities. More stringent regulatory capital requirements may force multinational parents of private banks to dispose of assets in the course of optimizing their balance sheets, especially in the case of smaller companies where the fixed cost of implementing new regulations becomes too burdensome. On the other hand, the sector is still significantly fragmented. Industry estimates suggest that the 20 largest wealth managers, who have a little over US$11 trillion of assets under management, only account for around 10 percent of the total private wealth available to be targeted.[1] The current turmoil is likely to stimulate consolidation of the industry. Those who are determined to expand their presence, especially in developing markets, should find significant opportunities to do so, but need to be prepared to act – to pounce – when necessary.

Potential

Significant potential remains, despite the pressures facing the industry. The Boston Consulting Group estimates that over the 5-year period ending 2016, private wealth will reach US$151.2 trillion, with an overall compound annual growth rate (CAGR) of 4.2 percent.[2] Within this total, growth in HNW and ultra-high-net-worth (UHNW) households is expected to be more rapid, at 6 percent and 7.5 percent, respectively. These investors are relatively more resilient than average retail investors. They have deeper pockets and access to timely and sophisticated advice, which also helps them ride out market cyclicality better. They remain an attractive prospect.

The big opportunities will increasingly be found in Latin America and in Asia. The Julius Baer Group, which currently derives one-third of its assets under management from developing markets such as these, expects this proportion to grow to over 50 percent by 2015. HNW individual wealth in Asia-Pacific region is forecast to grow at over 10 percent until 2016. More significantly, only around 17 percent of Asia's HNW individuals have wealth management relationships with their banks. Thus, a large pool of HNW individuals remains untapped.

This is not to say that success will come easily. New regulatory requirements will mean stronger processes for risk management, customer protection and capital management. Business models will have to remain flexible and responsive to rapid changes in the global distribution of wealth. The days of easy profits in private banking may be over, and rightly so, but significant opportunities remain for those who are prepared to grasp them.

The big opportunities will increasingly be found in Latin America and in Asia. For example only around 17 percent of Asia's HNW individuals have wealth management relationships with their banks.

1 Private Banking Benchmark 2012, Scorpio private partnership
2 BCG Global wealth 2012

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Beyond compliance: Putting an economic capital value on risk

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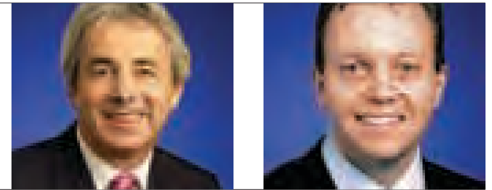

Many insurers are turning to their existing risk management functions and asking: How can we best optimize output to ensure value-enhancing performance?

Many in the insurance industry have traditionally viewed the risk function as simply the 'cost of compliance'. But this view is now being superseded by the need to understand how it can deliver wider business value. Throughout this article, we describe a new approach to articulating how risk management enhances economic capital and helps deliver growth.

For insurers, the last 10 years have seen risk management emerging as a separate function, the Chief Risk Officer (CRO) becoming a significant board-level role and capital and risk modeling increasingly being used to inform the way the business is run.

For many firms, this activity has been a response to regulatory drivers. Some markets that have been under intense pressure to deliver compliance to demanding schedules such as Europe, have invested heavily in standalone teams focused on the development of enhanced risk and capital frameworks. The result has been rapid and significant progress.

However, the infrastructure that has been built in such areas as risk analysis, modeling, own risk and solvency assessment, balance sheet management and controls has often been designed to achieve compliance rather than business value. Now, as the regulatory pressure eases and markets become more 'risk mature', the emphasis is shifting from compliance to competitive advantage.

How does the risk value equation contribute to increased return?

Risk value equation

Contribution to various KPIs

Risk value equation	Contribution	Key performance indicators (KPIs)
Increased return		
=		
Cost savings from risk mitigation	**Effective risk mitigation should result in reduced expected loss** by the business.	RAROC
+	+	
Revenue enhancements from risk insights	**Efficient data management and analytics** on risks should provide additional risk insights to further optimize business operation (i.e. investment strategy, product development).	Market consistent embedded value (MCEV)
+	+	
Reduced cost of risk capital	**Additional earning from capital no longer required to support risk** from reduced cost of risk capital (i.e. due to better S&P ratings) would help to increase return.	IFRS profit
–	–	
Cost of (operation)	**Fixed and variable operation cost** for improving risk management framework and process would reduce expected return but could be off-set by other benefits.	Solvency

Positive contribution to key KPIs

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At the same time, with many insurance markets around the world characterized by low-growth and flat-yield curves, senior management is under more pressure than ever to simultaneously grow and write profitable business, achieve a decent return on capital, reduce operating expenses and maintain robust risk and capital management frameworks.

Given these imperatives, it is not surprising that there is an increasing demand for risk functions to demonstrate how they add value to the business beyond compliance. If compliance is the sole aim, the value of risk management can be simply measured and expressed. But describing how risk management optimizes business value and helps deliver growth is now the key priority. This fundamental shift in expectations requires risk management to be viewed through a new lens.

A simple equation: A revealing insight

One lens through which the business value of risk management can be viewed is that of economic capital. In this approach, to add value beyond loss prevention, risk management must make a positive contribution to the risk-adjusted rate of return on capital (RAROC). This can be calculated from a simple equation (see diagram on page 31). In essence, risk management makes a positive contribution if the cost-savings from risk mitigation (effective risk mitigation should result in reduced expected loss by the business), plus the revenue enhancement from risk insights (efficient data management and analytics on risks should provide additional risk insights to further optimize business operation), plus the reduced cost of risk capital (additional earning from capital no longer required to support risk from reduced cost of risk capital) is greater than the cost of risk management across the business. By applying the RAROC equation, insurers can both develop a language with which to communicate the rationale and value of the risk management function as well as develop a set of consistent performance measures across the key business drivers.

For the risk function, the capabilities required for this new world of enhancing value as measured by economic capital are in no way different. The goal is to embed risk management more thoroughly in the firm's business processes, right down to the first line. To achieve this, a simple focus on frameworks, processes and roles is necessary, but not sufficient. Success also requires a significant change in attitude and, therefore, in culture.

Each firm has different business strategies, organizational arrangements and cultures. As a result, their strengths and weakness across the five risk management levers will vary. The first step for any firm, however, is to view its approach to risk management through the RAROC value lens and develop a detailed vision of the future using the five-lever framework. Gap analysis can then be used to compare where the firm is now with where it would like to be. Action plans can be created in order to lead to competitive advantage.

Perhaps the biggest challenge will be working out how to measure cost and value in order to demonstrate this to stakeholders. This will likely be far more challenging than simply demonstrating effectiveness, which may be seen as a given. The RAROC equation outlined above provides an intuitive way of measuring and communicating the business value of risk management. Applied to the five risk management levers, it also offers a quantifiable way of focusing continuous improvement efforts. Above all, it offers a language of risk that can explain in a straightforward way how risk management can add business value on an economic capital basis and support future growth.

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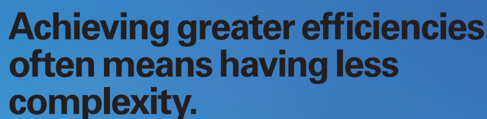

Achieving greater efficiencies often means having less complexity.

Enhancing risk management to deliver value: the five levers

The RAROC equation also provides a focus for continuous improvement in each of the five risk management levers. Enhancing risk management to optimize business value requires, for example:

1. **A target risk management framework** of structures, limits and policies that is based on a clear understanding of the risk appetite and is fully integrated with all other business processes; together with **a target risk management operating model** that describes how the framework is to be applied. Ideally, this would embed day-to-day management of business and financial risk in the business operations and in finance, leaving the risk function to take a strategic view of risk across the business. Overcoming organizational silos to assess risk allows for greater efficiencies, better flow of communication and governance of risk across the business.

2. **Governance and people arrangements** that provide clarity on reporting lines, skills and management roles. A first step is to articulate the primary functions and interrelationships of the CFO, Chief Actuary and CRO in a way that reflects their increased interdependency in the modern insurance world and, in particular, the convergence of risk and finance. Heads of business units need to be given the responsibility; information and tools to own and drive their own risk taking initiatives; including mitigation within the first line activities, to achieve their business objectives. All this is facilitated by having a clearly defined risk function at the business level, with well mandated terms of reference and the capabilities and empowerment to effect change. Greater clarity of roles and responsibilities can lead to greater performance and effectiveness of not only the risk functions but also many other functional units across the business.

3. **An integrated suite of risk and capital management processes** capable of identifying, measuring and aggregating the impact – and opportunities – of risk performance across the main suite of credit, market, liquidity, insurance and operational risks. These risk processes need to identify opportunities as well as threats – areas where because of its expertise and knowledge, its balance of business, or its geographical spread, an insurer can take risks at a lower cost (capital and revenue) than its competitors and so generate growth. Undertaking proactive analysis of new opportunities for risk positions enables the risk function to demonstrate the value it adds to the business over and above the traditional role of loss prevention.

4. **Risk, actuarial and accounting systems and technologies** that are compatible with each other and provide in an integrated way for economic capital, solvency and other outputs critical to business decision-making. Filtered key risk indicators and reporting criteria would then need to be built into the risk system to achieve optimal performance. In addition, modeling systems need to be capable not only of identifying the key risks to meeting current business objectives, but also of projecting future scenarios based on the relationship between risk, capital, and performance. By doing so, insurers can have a view into market movements as they develop, enabling management to quickly choose an appropriate course of action to address multiple contingencies.

5. **Reporting mechanisms** that are based on a clear understanding of stakeholder requirements regarding critical risk data and analysis. The process of analysis and review is as important to maintaining the risk framework as the reports themselves. This reflects the role of risk in the second line as reviewers/challengers/analysts rather than originators. Also, consistent reporting methodology and measurement of data is required in appropriate and consistent formats to ensure alignment across all business units. Such consistency should provide greater transparency to, and confidence from, key stakeholders allowing for a more accurate evaluation of the business by the market.

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Cutting through concepts: A recurring section which seeks to bring clarity around complex and often misunderstood financial services concepts or issues.

High-frequency trading: EMBRACE OR RESTRICT THE MACHINE?

Critics allege that it destabilizes markets, hinders price discovery and places conventional investors at a serious disadvantage. Supporters and practitioners argue that it promotes efficiency and increases market liquidity. Automated trading – especially algorithmic and high-frequency trading – is exciting increasing concern among regulators. Are they right to be worried?

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Algorithmic or high-frequency trading is one of the buzz topics of the moment. As a focus of popular discourse, it combines a number of appealing strands: fascination with the concept of money-making machines; a hint of advanced computer technology running out of control; and a good dose of financial market bashing. Commentators, journalists and bloggers compete to write scary headlines forecasting doom, gloom and economic collapse.

Nevertheless, with the various forms of automated trading now apparently accounting for the greater part of financial market activity, it is clear there is a real need to understand what is at stake and to form a judgment on its risks and benefits. Political leaders and regulators are increasingly worried. The Chairman of the US Securities and Exchange Commission has called high-frequency trading "One of the most significant market structure developments in recent years… By any measure, HFT is a dominant component of the current market structure and is likely to affect nearly all aspects of its performance."[1] In Germany, concern is so serious that regulators propose to act unilaterally, in advance of the development of pan-European regulation, and require ultra-fast computer-driven traders to be specifically licensed to operate.[2]

Definitions

This is an issue rife with confusion over terminology. It is important not to get bogged down in definitional discussions; nevertheless, a degree of clarity is valuable. High-frequency trading (HFT) and algorithmic trading are both subsets of automated trading, but have different characteristics and different purposes. Broadly speaking, *automated trading* refers to any electronic trading process where one or more steps are determined automatically.

In *algorithmic trading* one or more algorithms or varieties of decision-support software are used to automate the process of executing a transaction: this may be to trigger a sale or purchase at a specified price level; or it may be to automate the process of feeding a large transaction into the market in a series of small trades to minimize their impact.

By contrast, *high-frequency trading*, which is necessarily an automated process, involves fast or ultra-fast trading into and out of positions to take advantage of what may be very small and short-term opportunities. The most advanced HFT systems can now acquire and liquidate positions in fractions of a second. HFT automates, and dramatically increases the speed of, what are otherwise conventional trading strategies: spotting a trend or an arbitrage opportunity; taking a position; cashing out before the market moves in a contrary direction.[3]

Debate

The core question in the debate around HFT is whether the *quantitative* change in speed it brings is so dramatic as to constitute a *qualitative* change in the market. HFT systems

1 *Examining the Causes and Lessons of the May 6th Market Plunge,* SEC Chairman Mary L. Schapiro, Testimony to US Senate Subcommittee on Securities, Insurance, and Investment, May 20, 2010
2 Traders warn Germany on HFT licensing, Financial Times, 14 January 2013
3 See, for example, the discussion in *High-frequency trading in the foreign exchange market*, Markets Committee of the Bank for International Settlements, September 2011; and in *The Good, the Bad, and the Ugly of Automated High-Frequency Trading,* Tommi A. Vuorenmaa, Valo Research and Trading, June 2012

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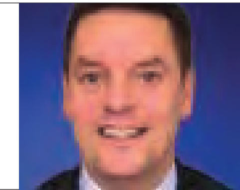

Critics argue that HFT creates significantly greater intra-day volatility in the market. The argument is similar to that applied for many years to automated and programmed trading as a whole: trades which automatically follow trends can exaggerate them, leading to excessive market movements.

can identify opportunities automatically and virtually instantaneously, faster than individuals can process information and form judgments, and complete profitable transactions with effectively no market risk. Does this capability carry significant risks?

Critics argue that HFT creates significantly greater intra-day volatility in the market. The argument is similar to that applied for many years to automated and programmed trading as a whole: trades which automatically follow trends can exaggerate them, leading to excessive market movements. HFT can dramatically increase this tendency, creating strongly-reinforced feedback loops.

Market regulators have looked to HFT as one of the prime causes of anomalous events, most notoriously the so-called 'Flash Crash' of 6 May 2010, when the US Dow Jones Index dropped about 1000 points (around 10 percent) in a few minutes. Subsequent analyses by regulators and by academics concluded that HFT was not responsible for the 'crash'. Nevertheless, the response of HFT firms rapidly drove prices down, which then infected the equities market. The principal consequence of the 'crash' has been psychological, concentrating attention on the perceived risks of HFT and increasing anxiety. Several more recent instances indicate that operational risk in the markets may be increasing. In August 2012, Knight Capital almost collapsed following a software change management error. This was followed by technical errors at NASDAQ and BATS due to instable software resulting from the on-going race to develop faster trading technologies.

Defenders of HFT argue that its prime value is in increasing market efficiency by providing liquidity and by improving the price discovery process. HFT poses effectively no systemic risk. Individual trades are targeted at very small price differentials, yielding very small profits. High-frequency traders typically close out all their positions within the trading day. Fast, automated trading is inherently more efficient than reliance on people, and it is difficult to argue against the proposition that in a perfect market the price discovery process should operate effectively instantaneously.

However markets are rarely, if ever, perfect: liquidity is never infinite; and every trade will have at least a minimal impact on prices. As the volume of high-frequency trades increases, more and more of the market consists of HFTs trading with each other. The prices 'revealed' by this process may move outside the range justified by fundamental factors. As to liquidity, it has been argued that above a threshold of specific economic advantage, excess liquidity increases 'herding' behavior and actually increases the likelihood of market crashes.[4]

Policy and regulation

Policymakers have two other significant concerns. One is that the growth of HFT may disadvantage, and disenfranchise, those market participants and investors without access to the massive amounts of computing technology employed by the major players, imposing a systemic economic penalty on them. As yet there appears to be no empirical evidence for this claim. However, various market participants do seem to feel disadvantaged, and this may have resulted in reduced trading activity from retail investors and institutional investors diverting their trading activities to dark pools. The second concern is less specific: it results from a general unease, greatly enhanced since the financial crisis, that any market which is not entirely transparent and comprehensible is inherently risky. HFT, which is sometimes referred to as 'black box' trading, is in this view the epitome of risk, not because it may or may not cause genuine market damage but because nobody is sure exactly what impact it does have.

However, in a recent major report, the Australian Securities and Investments Commission (ASIC) says it did not find any systematic manipulation or abuse of markets by high frequency traders; and that problems with HFT have been overstated.[5]

High-frequency traders are now responsible for 75 percent of equity trading, according to research by the Tabb Group cited by the Financial Times.[6] This fact alone means that regulators cannot avoid taking action. A number of technical measures are under consideration, including introducing mandatory delays, minimum tick sizes or 'speed limits' on trading, and developing automatic 'circuit breakers' which will suspend automated trading if markets become unruly. Through such changes it should be possible to control the risks HFT might pose without seriously damaging liquidity or market efficiency. In Europe, as part of MiFID II, a supervisory framework will be introduced covering algorithmic trading activities.

The European Principal Traders Association, speaking for high-frequency traders in the EU, has said it supports transparent, robust and safe markets with a level playing field for all market participants. However, it argues that the law recently adopted in Germany to require HFT firms to be authorised by their home regulators is anti-competitive and fundamentally undermines the European Single Market framework, as several countries currently do not authorize HFTs.[7] The Association stresses that the positive contribution of HFT should be taken into account when determining the appropriate scope for regulation.

As ever, the challenge for regulators will be to get the balance right: to deliver a greater degree of protection without serious adverse consequences.

4 See for example the UK Government Foresight Report: Crashes and High Frequency Trading, An evaluation of risks posed by high-speed algorithmic trading, D. Sornette and S. von der Becke, August 2011.
5 Dark Liquidity and High Frequency Trading, ASIC, report no 331, March 2013.
6 Catching the Electronic Trading Express, Financial Times 17 February 2013.
7 FIA EPTA, Position paper for the legislative proposal "Avoidance of dangers and abuse in high-frequency trading", January 2013

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As insurers struggle to identify new growth opportunities, the global market for micro-insurance offers enormous potential. But, as Jaco Van Der Sandt, Erik Bleekrode, Shashwat Sharma and Peter Ott explain, success will require new business models, simple products and a detailed understanding of individual customer needs.

Micro-insurance under the microscope: Market clarity the key to growth

Erik Bleekrode, KPMG in Brazil
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The last decade has witnessed strong growth in micro-insurance, especially in Asia, Africa and, increasingly, Latin America. India and China have been at the forefront: India alone is currently estimated to account for 60 percent of all the individuals covered by micro-insurance worldwide.

Overall, however, market penetration remains relatively small. As a result, there remains enormous growth potential. Industry estimates put the total number of possible customers at between US$2.5 and US$4 billion and value total potential revenue at about US$40 billion a year. Quite apart from the direct revenues, many of these potential customers are in emerging economies and can become increasingly valuable to insurance firms as they lift themselves out of poverty, acquire assets and have surplus income to save. We believe insurers are poised to make a big difference in the lives and well being of these people, developing innovative routes to market to tap into a viable revenue stream.

Strategically, there is a clear commercial incentive for firms to seek first-mover advantage by building positive relationships with low income groups. In addition, many governments and insurers feel a socio-economic and moral imperative to offer relevant products that help protect poorer people from events such as drought, the loss of a cow, or the theft of a plough, which can spell disaster. But for people living below the poverty line, who are often averse to buying an intangible service and suspicious of an insurer's willingness to honor a claim, the question is: why spend my precious dollars on an insurance policy?

As part of national socio-economic strategies, governments and regulators are responding to this question by raising the awareness and benefits of insurance amongst poorer demographics and providing the framework within which micro-insurance can operate commercially. As a result, in a number of countries micro-insurance regulations are being introduced that lower capital requirements for micro-insurers compared to traditional regulatory frameworks. They also simplify compliance, relax constraints on distribution channels and minimize licensing and examination requirements for intermediaries.

The need for a new approach

There is considerable socio-economic and regulatory momentum building behind micro-insurance and this is opening up new opportunities for profitable growth.

The key to success for insurers lies in recognizing the diversity of cultural, regulatory and economic environments across the individual countries of Latin America, Asia and Africa. This diversity means that a 'one size fits all' model for product design does not work. Insurers need to look beyond the traditional segmentation strategies around income, wealth, geography and age. Instead, they need to focus more closely on insurance needs and behavior and adapt their customer value propositions appropriately.

In Latin America, for example, and especially in Brazil, the micro-insurance market is focused on goods, particularly extended warranties for such items as cellphones and refrigerators. In India and Africa, on the other hand, where 60 percent or more of the population is involved in agriculture, on low incomes and living mainly in rural areas, the main need is to insure those assets that are vital to survival – cattle and other livestock and crops – together with life cover to protect the micro-finance loans with which these assets are often bought.

Nor is it the case that there is consistency even within a region – an extended warranty product that is a success in Brazil cannot simply be offered on the same platform and customer value proposition in Mexico, where the appetite for extended warranties is completely different. Equally, in some African countries funerals are major events and there is a strong market for relevant insurance distributed by burial societies and funeral parlors to community clubs. In other countries, death is not a suitable topic even to be raised in discussion.

Micro-insurance premium potential

US$0.8–1.2 billion

Potential Market

US$40 billion per year

It is estimated that the current penetration of microinsurance is close to 2–3 percent of the potential market

Source: Swiss Re Sigma Report 2010

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Apart from this market fragmentation, the low income segment has other inherent features that require a new approach. In India particularly, more extensive collaborative industry models may be required, with fast-moving consumer goods companies (FMCG), telecom, cellphone shops, local post offices, grocery stores and sellers of seeds, fertilizers and farming equipment bundling insurance cover with their products or services and sharing customer information. The distribution structures of regional rural banks, cooperatives and business correspondent models may need to be leveraged. And microfinance institutions may need to be even more engaged in selling life policies along with providing a loan. In Africa, bancassurance could play an increasing role as banks initially based in South Africa expand their operations across the continent.

Despite their poverty, brands can have a powerful attraction for those on low incomes. As insurers build confidence in their own brands, many policies are being sold as add-ons to products and brands that people already know and trust. For example, UK-based MicroEnsure is now conducting most of its business in Africa through partnerships with mobile phone companies; while high profile retail chains that have built their businesses in South Africa are now appearing in other African countries and offer enormous potential for the distribution of financial products.

Nevertheless, the dispersed, remote nature of this customer segment means that it is difficult to reach by intermediary and few low income people have PCs or internet connections. However, mobile penetration in the countries of Latin America, India and Africa is already high, with aggressive marketing of the benefits of the cellphone as both a communications and a payment tool. Mobile telephony therefore offers a huge potential; and those insurers who are serious about the micro-insurance market will have to tap into it.

Managing risk

Commercially, the low margins achievable on each policy mean that it can only be profitable if a great many standardized products are sold and managed through highly automated business models that are focused on a large volume of transactions and a low cost of operations. However, the high degree of automation combined with the simpler operating environment being put in place for micro-insurance will create challenges for insurers´ risk management frameworks. Especially since some micro-insurance regulation has allowed the use of specific channels – such as micro-insurance brokers, electronic direct sale channels – that involve less formal requirements and consequently will demand special attention in areas such as fraud prevention and money laundering.

Another factor to be considered is risk assessment and product pricing. Given the small premium size and the lack of both actuarial data and any history of pricing, it is difficult to quantify the sales volumes required to cover the risk. Reinsuring also becomes a problem. As a result, insurers will need to conduct greater research and analysis to achieve a better understanding of individual markets and people's needs. The right financial models will also be required to set the best pricing margins and help ensure customers are sold suitable products at appropriate prices.

Cross-industry collaboration to share costs and risks may also be needed, such as having a central company that specializes in handling claims or distribution, or creating common industry databases for micro-insurance. In India, for example, one option might be a pool of all the micro-insurance revenues accrued through initiatives run by insurance companies, the Government, postal services and through top-up or bundled schemes. Payment of claims could be managed by the pool based on information stored in smart cards or mobile phones.

Tailor products, lean systems

Above all, product design is crucial. The concept of simply transferring existing products to these new markets may be superficially attractive, but the reality is it will not work. The opportunity is more difficult: to develop and introduce new, tailored products.

What is Micro-insurance?

The number of micro-insurance schemes worldwide has increased substantially over the past five years and they now reach an estimated 500 million people.[1] But what is micro-insurance and why is it so important?

The risks micro-insurance products protect against are in the main fairly conventional – accidents, illnesses, death in the family, natural disasters and property, agricultural losses.

What is micro-insurance?

Micro-insurance refers to insurance products and processes designed to provide risk cover for the low-income population. These products have lower premiums and coverage limits as compared to the traditional insurance products.

What are the main micro-insurance products?

The risks micro-insurance products protect against are in the main fairly conventional – accidents, illnesses, death in the family, natural disasters and property, agricultural losses. The difference lies in the low incomes of the target

1 According to the Micro-insurance Innovation Facility of the International Labour Organization and the Munich Re Foundation, *Protecting the poor – A micro-insurance compendium*, Vol II, 2012.

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Success can only come if insurers talk to people, assess their needs and design their products to fit. In many ways, these are simple markets requiring simple products. For example, modularity may be an important principle. So instead of offering full-blown contents packages, micro-insurers might offer products that enable cover for single specific items, such as a TV. As the customer becomes wealthier and accumulates further assets, cover can be extended asset by asset.

In another example, many of the rural poor live in communities that essentially act as co-operatives to pool and sell produce grown by individual families. Insurers need to recognize how this social model can make life easier in terms of distribution, marketing and pricing – and offer these co-operatives relevant products like weather or crop insurance.

The need to keep operations lean means that, while products will have to be tailored, streamlined business systems and processes will have to be replicated as much as possible as micro-insurance is rolled out from market to market. All this requires insurers to think strategically about the global micro-insurance market in all its cultural, socio-economic and regulatory diversity, decide where they can compete successfully, develop innovative products, prices, processes, systems and business models and execute them faultlessly. Recognizing the lack of consumer confidence, insurers will have to build a reputation for fair treatment, honoring honest claims and processing payments quickly.

The challenge is considerable. But in these fast growing economies the potential rewards – in terms of both short-term profit and longer-term relationships as people grow wealthier and accumulate assets – could be great.

The key to success for insurers lies in recognizing the diversity of cultural, regulatory and economic environments across the individual countries of Latin America, Asia and Africa.

customers. Both the scale of the cover and the premium payments have to be tailored to their needs and capacity to pay. This also means product portfolios have to be closely targeted to specific markets.

At the moment, life insurance remains the most prevalent micro-insurance product because it is often sold alongside the credit provided by microfinance institutions. However, agriculture and health micro-insurance products are gaining in popularity; however, they can be complex in terms of underwriting and typically require a catalyst such as subsidized premiums.

How are micro-insurance products distributed?

Microfinance institutions and cooperatives are the preferred distribution channels because of their large established networks and proximity to the target market. Other existing micro-insurance channels include NGOs, community organizations, retail stores, trade unions, utility companies, religious faith groups, post offices and commercial banks.

The selection of the right channel mix primarily depends on the region and product segment.

Insurers seek to introduce distribution channels that are cost efficient and offer a wider reach. Modern telecommunications technology is already being used, with mobile banking gaining prominence in both client communications and in premium and data collection.

What about the regulatory environment?

Most insurance regulators propose lower capital requirements for micro-insurers compared to traditional insurance. In the main, micro-insurance regulations are aimed at ensuring simple, easy to understand products and encouraging new and innovative distribution models, such as banking correspondents.

Outlook

Governments, insurance companies, NGOs and others are keen to raise awareness of the risk management benefits of insurance amongst low income groups. Government participation through NGOs, public-private partnerships and community- based organizations is also likely to help enhance the market for micro-insurance as they work to bring people out of poverty. As a result, there is significant growth potential if the micro-insurance industry can successfully develop the necessary low cost, simple products and distribution channels.

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The US banking sector is ripe for consolidation – as it has been for the past 20 years. True, the number of banks is continuing to reduce steadily through closures, mergers and acquisitions. But the major wave of consolidation which is often forecast remains elusive. Could it be different this time?

Are US banks ready for consolidation?

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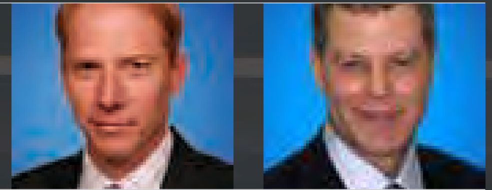

Twenty years ago, there were 14,000 commercial banks and savings institutions in the US insured by the Federal Deposit Insurance Corporation; 10 years ago, that figure had reduced to 9,000; and the total stands at just under 7,200 today.[1] Despite this steady reduction, the consensus of opinion among industry professionals, regulators, and government officials is that 7,200 is still too many. Each year there have been regular predictions of a coming 'wave' of bank mergers and acquisitions which will cause bank numbers to drop precipitously in the very near future.

In the past few years, the much-heralded wave has been – at best – a ripple. There were 236 deals announced in 2012, up from 178 in 2011, although the total deal value was lower at an estimated US$13.7 billion against US$17.1 billion the previous year. Nevertheless this year, there is again no shortage of prognosticators making the same forecast. This article looks at whether or not it might be different this time.

Consolidation forces

The forces favoring consolidation have strengthened significantly since the financial crisis. Principal among these have been the major new regulatory initiatives aimed at strengthening systemic stability, protecting consumers and investors and constraining undesirable banking practices. At one extreme, political leaders and regulators alike are struggling to limit the risks posed by systemically important financial institutions, and avoid the dangers of banks too-big-to-fail. At the other end of the scale, however, regulatory change has made it much more difficult and costly for small banks to remain compliant and sustain profitability.

There is a 'goldilocks' range of bank size emerging which is neither too big nor too small but 'just right'. At the lower limit, the industry consensus is that the smallest sustainable and profitable size for a bank is now US$1 billion in assets. As pressure mounts on many of the US banks with less than US$1 billion in assets to manage the costs associated with new compliance demands, there is mounting speculation that many will be forced to consider merging or even closing.

The failure rate among small and medium-sized banks has slowed dramatically now that the worst impacts of the financial crisis have passed. The implication is that if consolidation is to proceed, and accelerate, then it will be via mergers and acquisitions. But the market still remains largely 'stuck'. This is primarily a result of the continuing mis-match between sellers' and buyers' perceptions of value. In many cases, bid-offer spreads remain too wide to be bridged where there is no decisive reason for a deal to be struck.

Price constraints

The reasons are well-documented: Potential sellers look back to just a few years ago, and recall deals being struck typically at multiples of at least two times book value. There is still an expectation, or at least a hope, that multiples will return to those levels in the near future. In fact, while book values in completed

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1 Statistics at a Glance, Federal Deposit Insurance Corporation website, www.fdic.gov, retrieved 9 February 2013

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transactions are creeping upward, they have much ground to gain before approaching pre-crisis levels.[2] The median price to tangible book value was about 120 percent in 2012, compared to about 106 percent in 2011. Those ratios are a long way from the three to four times price-to-book rations of a decade ago, and a return to those levels appears unlikely in the near term, given the current environment of thin margins, low lending activity, and low interest rates.

If they are not being compelled to sell as a result of regulatory or financial pressures, many sellers are having difficulty accepting that their institutions can no longer – at least in the current market – demand historical price levels when it comes time to sell. Buyers, for their part, are requiring a better perceived deal to make transactions possible: asset risks and continued slim margins are compelling acquirers to offer less than past multiples or find a 'perfect fit' in order to display an accretive deal.

Greater realism?

The situation is changing. Greater realism is entering the picture, on both sides of the buyer-seller divide. Boards of struggling banks are recognizing the challenges of continuing to compete in a difficult environment. Demand for commercial and industrial lending remains weak; interest rates are at a historic low; requirements to hold regulatory capital are increasing. Directors and shareholders see the adverse impact on profitability and on return on equity, and are coming to realize that poor core earnings are not going to improve in the near future. Moves to eliminate or ring-fence proprietary trading bring further constraints. Continuing negative sentiment around the banking sector only magnifies for some the feeling that it is now time to strike a deal. On the buyer side, successful and profitable banks are beginning to be more willing to take the risks of acquisition combined with their increasing currency to do a deal.

Regulators, too, are indirectly encouraging consolidation. As we have seen, more stringent regulation is having two impacts: limiting more risky strategies and hence reducing profitability; and imposing higher compliance costs. All encourage the propensity to sell. While regulators cannot directly intervene to force profitable banks into mergers, it is clear that certain types of deal will receive favorable responses.

Strategy and prospects

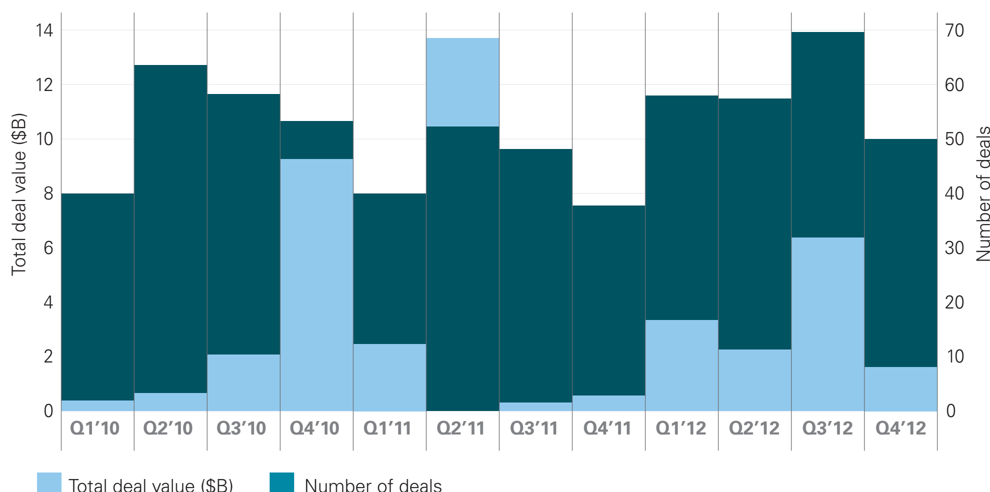
In this environment, deals driven purely by short-term financial considerations are likely to remain in the minority. What we are seeing, and will increasingly see, is banks becoming rather more willing to act when an acquisition advances corporate strategy. This does not mean buyers are willing to pay over the odds; but deals which advance their wider strategy are more welcome. These may facilitate expansion into other geographical areas, allow the enhancement of product capabilities, or offer the prospect of reduced unit costs through increased scale and platform convergence.

The current environment is also stimulating bank acquirers to explore different transaction structures and risk profiles. Recent transactions have predominantly been acquisitions of distressed banks by healthy institutions, however, other structuring options – such as pre-packaged bankruptcies – may be evident in the coming months. The balance between cash and stock in successful transactions will hinge on the perception of marketplace improvement, which remains difficult to predict. However, as stock prices recover, so will the attractions of paper-based deals.

Conclusion

It is too soon to call the scale of bank consolidation in the near future. Nevertheless, smaller institutions will continue to face profitability challenges and shareholder activism to sell - putting more pressure on them to merge. We expect buyers to remain concerned about current price levels, as well as issues associated with capital preservation and potential surprises. Although the picture may change, while buyers lack confidence in the future it is likely that current bid/offer spreads will continue through 2013, which will keep activity relatively low. The 'wave' will be another ripple until the pressures on the seller increase.

Quarterly bank & thrift deal statistics



Data as of December 31, 2012
Branch deals and government-assisted deals are excluded.
Includes terminated deals.
Excludes Merger and supervisory conversions.
All metrics are as of announcement date.
Source: SNL Financial

2 "Bank M&A 2012: Dealer's Digest," SNL, January 4, 2013

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BROADER IMPLICATIONS

What does this all mean for US banks in the international context? and for foreign banks looking to expand in the US?

Under Federal law, broadly speaking, no US bank is allowed to control more than 10 percent of domestic deposits as a result of a merger with another bank holding company (known as an Intermediary Holding Company). The largest banks in the US (JP Morgan and Bank of America in particular) are just about at this limit, which means that any further expansion via acquisition involving deposits will have to be outside the US. Some banks have also viewed acquisitions outside the US as potentially greater growth opportunities than in the US.

Looking at foreign banks' current penetration of the US market, their share of total US banking assets was only 14 percent as of 31 December 2012. Out of the top 50 banks operating in the US, only 9 are non-US banks.[3] Some foreign banks such as BBVA have explicitly stated in their strategy that the US is a key growth area. However, recent suggestions by Federal Reserve Governor Daniel Tarullo that foreign banks operating in the US should have to hold billions of dollars in additional regulatory capital could lead to radical changes in strategy, and force many foreign banking organizations to pull out of the US market.

The balance between cash and stock in successful transactions will hinge on the perception of marketplace improvement, which remains difficult to predict. However, as stock prices recover, so will the attractions of paper-based deals.

3 HSBC, TD Bank, RBS Citizens, BMO Financial Corp, UnionBalCal Corp, Santander Holding, BancWest (wholly owned by BNP), BBVA and Deutsche Bank

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Insolvencies change the investment landscape

Richard Faulkner, KPMG in the UK

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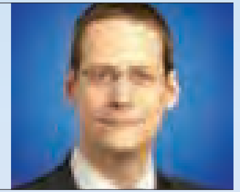
Richard Faulkner



The bankruptcies of Lehman Brothers and MF Global sent shockwaves through the investment industry. The issues raised could have fundamental implications for the ways investment firms do business, manage their liquidity and treat customer assets. As regulators respond, Richard Faulkner discusses where the existing system proved inadequate and the implications for both investors and investment firms.

In one of the largest bankruptcies in US history, futures broker MF Global entered insolvency in the US and the UK at the end of October 2011. In the US, the Securities Investor Protection Corporation initiated the liquidation of MF Global Inc. under the Securities Investment Protection Act. The UK affiliate, MF Global UK Ltd., became the first company to be placed into a new special administration regime for investment banks. Richard Fleming, Richard Heis and Mike Pink of KPMG in the UK were appointed as Joint Special Administrators.

Subsequently, more than US$1.6 billion had been reported as being "missing" from MF Global's US client accounts at the time of the collapse. It has been alleged that MF Global used client money to trade from its own accounts, in contravention of regulations requiring segregation of customer assets. Allegations of improper behavior aside, experience with the MF Global collapse and subsequent insolvency proceedings highlight four main structural weaknesses in the way the sector operates.

First, the law surrounding the insolvency administration of global investment firms like MF Global is complex and has not kept pace with the scale and global nature of the businesses involved. In the UK and Australia, for example, the legal principles are founded in the common law concept of trust and are steeped in often long-established case law, the set of existing legal rulings that can be cited as precedent. The problem is that insolvencies of large global financial entities are new and the case law is limited. This means that during the insolvency, there are no existing answers to many of the issues and the parties have to go to court for a ruling – a costly and time-consuming process during which client assets (both money and securities) cannot be returned.

Second, there is inconsistency between jurisdictions in the rules on important operating issues like segregation of client assets and rehypothecation of collateral. For example, under US rules, a prime broker may rehypothecate assets to the value of 140 percent of the client's liability. But in the UK, there is no statutory limit on the amount of assets deposited by clients that can be re-hypothecated. It is up to clients to negotiate a limit, or prohibition, on hypothecation. When the investment firm is global, such differences create opportunities for regulatory arbitrage in which client assets may be shifted from one jurisdiction to another.

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Third, it appears with MF Global that clients may not have fully understood what they were signing up for. US clients of MF Global appear not to have been fully aware of the differences in legal protection between jurisdictions. They simply assumed that the protections afforded by US legislation would apply and were largely unaware of the extent to which their agreements allowed the broker to move certain assets outside their local jurisdiction to take advantage of international variations in regulation. The same happened with Lehman Brothers.

Even apparently sophisticated financial entities that were clients of MF Global may not have done their due diligence, read and understood the fine print of their agreements and thought through the implications of the powers they were granting their broker to leverage their assets in pursuit of its own business activities.

Fourth, there is a common misperception about the insolvency process and, in particular, the retrieval and return of client assets. There is no readily accessible discrete bank account for each client's money that can be closed and the funds disbursed to that client. Quite the reverse. Ownership of assets can be unclear and open to legal challenge. The Lehman insolvency has been shrouded in so much litigation that, some five years into the insolvency, substantial amounts of client money and assets have yet to be returned. This problem has been recognised by regulators. For example, the new special administration regime in the UK is specifically intended to speed up the return of client assets by tracing specific assets handed over for investment and returning them to the investor. But these assets still have to be carefully tracked within the labyrinthine global financial systems used by international investment firms to optimize business performance. In the case of MF Global, there was the additional difficulty in the US of finding where the US$1.6 billion went, as well as complex legal issues surrounding the ownership of MF Global's assets – and especially the large exchanges of funds between the US parent and its UK unit in the final days of the firm. MF Global went into insolvency over 16 months ago. Still the work of recovering assets and proving ownership goes on, although there have been some positive developments in the form of a high projected payout to clients and creditors.

Strong reaction

Understandably, investors are demanding a greater level of protection and faster recovery of their assets in the event their investment firm fails. In response, regulators around the world are reviewing their rules concerning the segregation of customer assets with a view to strengthening protection, preventing assets going missing in future and making the assets more readily available to customers in the event of insolvency (see table above).

Evolving regulation in different jurisdictions

Jurisdiction	Developments
Australia	In response to the collapse of MF Global, the Department of the Treasury has identified the need to examine the client money provisions in the Act with a view to determining whether they provide sufficient protection for investors.
Europe	The European Markets Infrastructure Regulations (EMIR) introduce requirements for the segregation of balances relating to centrally cleared business.
United Kingdom	The FSA has started a fundamental review of the client money and custody assets regime. The fundamental review is focused on improving the regime to lead to better results in the insolvency of a firm although it is important to recognize that insolvency law is determined by primary legislation and not the FSA rules. The review will take lessons learnt from recent insolvencies, such as Lehman Brothers International and MF Global, and is intended to assess the industry's appetite for change.

However, while there is a clear need for greater alignment between jurisdictions, at the moment it is difficult to see how this will be achieved unless the regulators coordinate their reviews and the legal principles of insolvency in those jurisdictions allow for greater cooperation and coordination (currently it relies on the skills and attitudes of the various Insolvency office holders).

Implications for investors and investment firms

Whatever the outcome of these regulatory reviews and however strong client asset protection becomes, experience with MF Global and Lehmans suggests investors will have to play a more robust role in the future and recognize their responsibilities as 'informed buyers'. This means understanding the fine detail of the agreements they have signed and deciding whether they provide, in reality, the level of protection they want.

For investment firms, this tightening of regulation may have profound implications. For example, if rehypothecation of all client assets is severely circumscribed or banned altogether, this may mean the loss of a major source of funding. Similarly, if an investment firm's access to excess margin is restricted, this may limit its ability to earn income. If full segregation of client assets is demanded, this will require fundamental changes to the business model. This is likely to be challenging in a time when margins in the sector are, at best, slim.

Actions being taken by regulators to accelerate the return of client money after insolvency will also create challenges. For example, the UK Financial Services Authority's proposal for multiple client money pools would prove operationally challenging for both investment firms and central counterparties, both in terms of day-to-day reconciliations of those accounts and the requirement to notify clients about the pool to which their dealings relate. Nor is it clear that such a change would, in practice, speed up the return of client money without complementary changes to the legal framework governing the insolvency of investment firms.

Other emerging regulations may change the way investment firms manage their client relationships. For example, a comprehensive repapering exercise will be needed to establish a new baseline, contractual terms will have to be reviewed and potentially revised, more transparency and information will need to be provided and more reconciliations will have to be conducted with investors. All of this will require operating models to be re-examined, driving up the cost of doing investment business and, potentially, leading to higher charges for clients.

This is not just an issue of compliance with an increasingly complex set of rules. The changes post-MF Global and Lehman may have a fundamental impact on the investment industry's business and operating models. At the same time, clients can be expected to demand more transparency and greater contractual protection. It is vital investment firms now review their business models and operating practices in the context of an in-depth understanding of both the future direction of regulation in relevant jurisdictions and the spirit of customer concerns. Armed with this knowledge, they can ensure they have their house in order and position themselves for success and growth in a very different regulatory and business environment.

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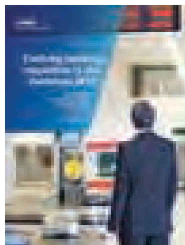

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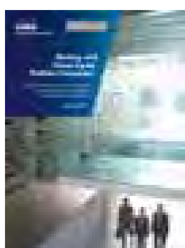

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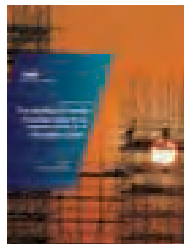

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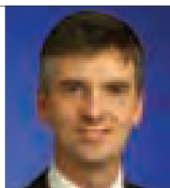

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