Putting Together the Pieces of the Global Bank Puzzle

Global banking will be transformed in the years immediately ahead by regional growth differences, new regulations and a need for technological step-change. To gain some insight into these and related issues, Knowledge@Wharton spoke with Mauro Guillen, a management professor at Wharton, who also is the director of the Lauder Institute, and with two Ernst & Young executives – Ian Baggs, deputy global bank leader, and Marcel van Loo, the European banking leader. Additional topics discussed during the interview were the following: repositioning risk management; customer-driven vs. a bottom-line approach; and Tier I capital reserve requirements under Basel III.

An edited transcript accompanies the videos.

Introduction:

Knowledge@Wharton: Thank you for joining us today gentlemen at Knowledge@Wharton. We are here to discuss global banking and capital market issues with Mauro Guillen who is a management professor at Wharton and also director of Wharton's Lauder Institute of Management in International Studies. We also have from Ernst & Young two executives – Marcel van Loo, who is the European banking leader, and Ian Baggs, deputy global bank leader. Let's start by looking at some of the key themes that have large implications for the future of global banking and capital markets.

Repositioning Risk Management

Knowledge@Wharton: How should banks reposition risk management within their governance structure to empower and to satisfy regulators?

Ian Baggs: Well that's got to be right at the top of the agenda for all of the institutions. Regulation is one thing and it is important to meet the requirements of regulation. But for most boards it is going to be more front-of-mind that they want for their own purposes – [to determine] what risk the institution is in. So I think it does move the risk question further up the chain. We have seen a number of studies come out which are going to suggest that the risk function is involving some of the non-executive directors in that discussion, and there is a lot more challenge from non-executive directors to the board and to executive management about what risks have been taken in the business.

Knowledge@Wharton: Mauro?

Mauro Guillen: I was thinking it has boded very well. The responsibility for this needs to be shifted up in the organization. And the boards may need to be somehow restructured a little bit in terms of the various committees -- and also their composition – bringing in more independent directors – outside directors – with the expertise to assess whether the bank is in trouble or not with its various products.
Knowledge@Wharton: Do you see a similar take in Europe?

Marcel van Loo: Absolutely. If you look back at the crisis I think the important lesson is basically that [in] the risk management field, there needs to be and there are a lot of new rules. Regulatory supervision I think this is key to avoiding sort of a huge crisis about improving risk management. So I think it is really at the top of the agenda.

The Difference between a Customer-driven and a Bottom-line Approach

Knowledge@Wharton: How would you distinguish between customer-focus and bottom-line focus? Would you give a couple of examples of where key decisions would need to be made in order to go down one road versus the other?

Marcel van Loo: Well, if you think about bottom-line focus you may think about the short-term. You may think about maybe proprietary trading. And, whereas, I think banks in the future will have to look how they can support and fulfill the needs of their customers I think that is the only way to stay in business. Now, that doesn’t mean to me that they will simply ignore the bottom line. A bank is a commercial organization that has to make a profit, which by the way is going to be a big challenge going forward because I think it is very clear that we will not see the level of profitability we have seen in certain years before the crisis.

But, I think the way to become profitable and sustainable is just by focusing on the customer. So I don’t think it is mutually exclusive. But I think they have to start with the customer and then automatically they will be a profitable and sustainable business going forward.

Knowledge@Wharton: Mauro, from your point of view, the idea being customer focused -- what does that look like on the ground? In other words, what do banks actually do?

Mauro Guillen: Well, they go out of their way to please the customer within of course the constraints that they need to be profitable. And I think that regarding this whole issue there may also be a situation in the near future in which the market just produces different types of banks.

So some of them may be more customer-focused. Others perhaps are more willing to compete on the basis of cost and the bottom line, and they will attract the customers that are not that interested in special treatment but rather in the lowest possible fees or prices for their products. So there could be also some specialization. But I fully agree that if you want a sustainable position in the banking business you need to be customer focused. There is no question about it. But there is always going to be some bank that wants to go after the low end of the market and that's healthy for the system.

Knowledge@Wharton: So from a global point of view there will be some differentiation around this issue, but your advice I take it would be for most banks to pursue the customer-focused approached.

Ian Baggs: I think in any business you need to think about your customers and I think as Mauro was saying that’s where the start is – the customer focus. But there are different types of customers. And arguably if you look back over the last ten years, one of the things we have seen in many different types of banking business – and I think it’s true pretty much globally – is that there have been very high profits made across many different types of business lines, and arguably management has not really had to challenge itself about where those profits have been generated and how sustainable they are.

So I think one of the things that we see a big focus from most banks on at the moment is something that Marcel was talking about: It’s this linkage between your customer focus, and understanding the value of the different franchises that you have within your business, back to the ability to generate profits from that. And actually implicitly from that there is a real focus on what capital you have to support that business.

So one of real challenges for banks is: Do you have enough granularity in understanding the metrics within your business and what the dynamics are about the profits you can generate off different types of business versus the risks of being in that business. Some banks are probably better positioned today because their information systems have given them the ability to get into that granularity. Others have got to go some way to improve that microscope that allows them to look down into the business and really examine whether it is a business that they can stay in for the long-term.
Technology Investments and Employee Training

Knowledge@Wharton: Marcel, perhaps you could address this idea of technology. What kinds of investments are going to have to be made by banks and how it is different than what has happened in the past?

Marcel van Loo: I think technology is key not only to fulfill the requirements of the regulators but also banks will be challenged in making a decent return for their shareholders. They will have to use technology and technology improvements to improve productivity. For me that is absolutely a key part of going back to a decent return to their shareholders. We have seen also with our clients that already, today, a lot of investments are being made, and not only with the view of satisfying the regulatory needs for information or to come up with better business information and management information on clients or risk. But also I think (technology investments are being made) to make the target operating model more efficient and to reduce cost.

Knowledge@Wharton: Mauro, what would be your view on that?

Mauro Guillen: Well, undeniably, yes. Technology is going to be very important in all the different segments of the market, starting with retail and all the way up. The good banks far down the road are likely to be perhaps the ones that make the best investments in technology – the ones that avoid the usual rule of thumb, which is that you invest – like in advertising – you invest $100 billion and then you know that $50 million are going to work and the other $50 million are not going to work. Right? But the problem is, of course, that at ex ante you don’t know which of the $50 million are really going to be useful to you. So I think it is going to become a major discriminating factor between a good bank and a bad bank in the near future. How effectively can they deploy more technology and gather information obviously for market purposes and not only for the regulators? I think it is going to be a huge source of competitive advantage for the banks who manage to get it right.

Ian Baggs: I think that is absolutely right and I think that this distinction, if you like, of not just focusing on the straight-through nature of processing, so that it is controlled and well understood all the way through to the financial settlement of transactions, but the front end connection to clients (also) is massively important. And, arguably, a lot of the major banks have invested a lot of money over the last several years in improving the front-end system. They now need to, in some cases, invest more in the back. And I think you could say that at the moment there are some banks who, because they have invested more regularly over the last five or 10 years, it is giving them an advantage now because they just compete to keep investing more in the front-end platform. But for other firms they have to work out within the profitability of the business they have got have they got actually to try and catch up on the under investment that some of them perhaps have got to deal with.

Marcel van Loo: To add to that, you can see that a lot of the banks had to remediate back office systems and to fulfill the requirements by the regulators. They are very challenged because actually what they want to do and need to do – going back to the first topic on customer – is to connect with the customer. And there are some great opportunities if you think about social media and the Internet to do that. That is the challenge a lot of the banks are facing -- that they have to spend so much effort and money in their back office that they are afraid they are not able to spend enough on sort of the connection with the customer.

Knowledge@Wharton: So it is interesting. It sounds as if the technological capability is out there and pretty much understood. It is coming up with the funds and allocating them properly.

Mauro Guillen: And training the employees. Information technology – I’m sure my colleagues here on the panel know very well – because of their advising to banks, is not only about the hardware and the software. It is also about the interaction between that and the employees throughout the organization. And [it is] also how information technology can help the bank develop horizontal linkages and information sharing, especially when you are trying to develop a 360-degree view of the customer. So that is I think the real challenge. Coming up with the funding – sure – that’s also important. And you always know that you are not going to get it exactly right. But training the employees as to how to use the technology effectively – at least in my experience with banks – is of utmost importance.

Ian Baggs: It is very important. There are banks that have over time invested in more globally consistent systems. And that becomes quite interesting when you are trying to move some of your key people around the world. This whole talent pool that you have in your organization, which depending on the business and the way it develops you might want to move some of those people around the world. If you are dealing with the same set of systems as you go around the world this makes life much simpler. People understand it. It is a consistent language that you are talking within the organization. And you understand the functionality of what you have to deal with whereas at other firms where maybe it has been built up over many years through different mergers and acquisitions this can be very complicated to deal with.
Front-end Technology Investments

Knowledge@Wharton: You made a point earlier that I wanted to elaborate on a little bit. Perhaps each of you could offer a view on the idea that some banks have done very well investing in that front-end and others haven’t done as well and will probably have to catch up. Can you elaborate those who have done it well what that front-end investment looks like? What is it that the customer is seeing for those banks that have done it well that they are not seeing from other banks?

Ian Baggs: Examples would be in the equities market where I think the top-end firms have invested heavily in electronic distribution platforms. There are different ways for customers to connect with them so that you don’t necessarily have to speak to somebody, but you can get a price on the way that some of the different pools of liquidity have emerged in the market that you can then provide access to for your customers and your client base, too. These things have been important in giving ongoing development to those firms and keeping the expansion of their franchise going.

So it becomes maybe not a question of are the firms under-investing, but it becomes quite difficult to get into that market if you are not already in there because the cost of entry is very significant indeed. If you took another example around, say, prime brokerage, then the amount of support that you can provide to your client brokerage customers in terms of them understanding the portfolio that is being run might include; what the valuations are so that they can see the risk profile of their portfolio running with you; and how the collateral is being managed against that and the collateral charges that you are taking. Those things take an awful lot of complex technological connection. But it does give you a distinct customer advantage in terms of how the customer perceives each individual bank.

Marcel van Loo: And it may be taking it to the retail customer, although we have always said, and probably it is still true, that to enter into the banking market it takes a high investment. We have seen quite a few in Europe of successful new online broker firms for retail customers. And you sort of wonder why our traditional banks – the established banks – are unable to tap that potential. And so I’m actually quite confident that we will see also in the near future new parties joining the banking market, especially in the retail space.

Knowledge@Wharton: So expect new entrants using technology as their differentiating edge?

Marcel van Loo: Yes.

Will Banks Continue to Pursue Complex Investment Vehicles or Focus on Core Competencies?

Knowledge@Wharton: Do you think banks will continue to focus on developing new complex investment vehicles? Or will they focus on core competencies and scale back somewhat on the more risky and sometimes more profitable financial products?

Mauro Guillen: Do you want a wishful answer?

Ian Baggs: So the answer is, “Yes.” I think we have already seen that since 2008 the complexity of product that people are interested in having as an investment has gone way down. And so the very high margins that some of the banks were able to make out of very complex products has disappeared. And they have had to refocus the business much more on large flow, big volume of more homogeneous product sets. So I think that has already largely happened.

Where you still see some complex vehicles set up – where you still see some product complexity – if that is the risk management or investment solution that a particular client wants, yes. The only question is, are they prepared to pay the price that goes with it? And I think it is going to be driven much more by the capital implications for the bank as to how they are going to price that into the product and whether that then works for the investor.

Knowledge@Wharton: Because presumably they will be required to have more reserves against that kind of an investment, which affects margins and so forth.

Ian Baggs: Absolutely.

Marcel van Loo: I absolutely agree. I don’t think the client demand is there at the moment. So I think it is very much driven by the clients now. Of course, people tend to have very short memories so it could well be that in
five or 10 years from now we will see some new financial innovation. But I think for me it all depends on the client whether there is appetite from the clients to invest in these new products.

Knowledge@Wharton: Mauro?

Mauro Guillen: I totally agree. If they becoming niche products then from the system point of view what you would like is niche outlets or banks, or middle institutions then catering to that market so that the large institutions then are not prone or not exposed to that type of risk. So if this becomes a niche market then why not have specialized banks or outlets dealing with that so that the bigger institutions then can focus on something else and in that way reduce systemic risk.

Ian Baggs: I think that’s absolutely right. I think it is interesting when we have all talked about what the market is looking for and what the customer is looking for. Essentially when you look at now versus five years ago we have customers – retail and wholesale – who have low risk appetite. Whereas heading through 2005, 2006, 2007, most customers were living in a very low interest rate environment around the world. And they were looking for a higher level of return than they could get through normal products. And a lot of the proliferation of complex products came because whether it was a pension fund or an investment firm or whatever the vehicle was – right down to retail investors wanting to get hold of small chunks of bonds through their local bank -- they wanted to get a high rate of return and they were prepared to take the risk of those products as a result. Clearly in the environment that we are in at the moment no one has got that appetite. But who knows, as you were saying, what might change in five years time?

Marcel van Loo: Absolutely.

Tier I Capital Reserve Requirements in Basel III

Knowledge@Wharton: Global banking regulators under Basel III will now try to identify spikes in credit growth that might create a bubble – a credit bubble – within an individual country. Once a country has been found out to be overheating, or to have a bubble brewing, that country’s banks would have to increase reserves under the Tier I mechanism -- perhaps by as much as 2.5 percentage points. And foreign banks – this is the interesting part – foreign banks operating in that country would also have to increase their reserves by some amount, which would be proportional to the amount of business that they did in the so-called bubble-pumping country. This was a little-noticed item that came out of Basel III, but has potentially huge implications and is very interesting because it is – if it worked – a huge step in coordination among central bankers in a way that hasn’t been done before. What is your view of this? And does it have much of a chance of actually working in practice?

Mauro Guillen: I think it is in part an attempt to bring into the rules and regulations the idea of dynamic provisioning. So when things are going okay and you see this build up of a bubble, then you actually ask banks to provision more – to put aside more money because presumably they are making profits at that point for the rainy days. So in part I think it is an attempt to invoke or to introduce that principle, which I think is a very sound one. What I’m not so sure [about] is whether actual coordination will be possible of the various banking supervisory authorities in different countries. Maybe in Europe because they meet regularly, but to do that on a global basis I think it is going to be really hard. We talked earlier about the challenges of coordinating all of these things globally. But the principle itself – as long as we are talking here about dynamic provisioning – I agree with it. But I think the implementation of the coordination aspect of this is going to be really tough.

Knowledge@Wharton: Do you think they can actually identify a bubble?

Mauro Guillen: The problem with bubbles is not so much identifying it but rather predicting when it is going to burst. Right? So we know when the bubble is building up. But the hesitation is always, “We will just let it go for another year because there is no reason to be worried about it.” The problem is – my view is that everything is about the timing and the prediction of when it is too early to tell or too late to activate the mechanisms to try to bring it under control. You don’t want to burst a bubble too early. You want to enjoy the job creation. It is a fine art. This is the problem.

Marcel van Loo: Nobody wants to ruin the party.

Mauro Guillen: Exactly.
Marcel van Loo: I fully agree. To be quite honest, I was quite impressed when the crisis broke out – impressed by the almost unprecedented international cooperation. And I like this concept. I think we need to be very realistic about the chance of really seeing it in practice. Because I think also nowadays you can see that there is more difficulty in the international cooperation. You can see that also in Europe – that even in Europe – local regulators try to do their own thing, which is a big problem for our global banks because they not only face one regulator but they may face 50 or even 100 regulators globally. And also I think if you look more at the global level there is quite a difference between Europe, the U.S. and the emerging markets. It is a nice theory but I don’t think there is a level playing field, and so if you take that as a starting point I think it is very difficult to see effective international coordination.

Knowledge@Wharton: From a global point of view it is almost as if they have set up a software program that is running in the background and there is this statistical model that says, “Okay. We have spotted this bubble.” And then it is almost an automatic stabilizer that is supposed to kick in, in theory, maybe taking out some of the human judgment, which seems something that is questionable. So we have got all this complexity even just within Europe and now, as you say, we start to look at the global level it really starts to look difficult.

Ian Baggs: This is very complicated and I think, as Mauro was saying, economically you can see the sense of the idea and the mechanism. But how you make that work in practice is very difficult. When we look back at Europe the way that Basel II was implemented across Europe, the way that other things have been implemented from a regulatory perspective – the E.U. sets the policy but individual countries implement in the way that they think it should be implemented and the way they think it is in accord with the policy. So there are huge amounts of differences in the way this works. And we do see still a massive amount of national interest as you were saying. Perhaps back to where Mauro started here, which country and which government is going to be the one that raises its hand and says, “Yes, we accept what the model is saying and this is the time.”

The Outlook for Regional Banks

Knowledge@Wharton: Well, we have talked about a lot of different things here – financial regulatory reform, risk management, growth and derivatives. There are a lot of pieces out there, a lot of uncertainty, and it could maybe be looked at as a puzzle, because with all of the uncertainty no one really knows quite how it is going to fit together. But I am going to ask you to try to give an overview – in just a short minute or two for each of you – of how you think all this will fit together in say the short and medium term, and what kind of climate are banks likely to be operating in? So, Ian, perhaps we could start with you?

Ian Baggs: At the start to this it was very much like a giant jigsaw puzzle. You didn’t have all the pieces. And you didn’t have a picture to follow as to how you put it together. That is very complex for organizations that are truly global in nature or even covering a large region to put this picture together. I think something we have seen as firms have taken a lot of time to try and think it through is that they have worked out something now about which products, which business lines, they think they want to be in or their regulator will allow them to be in and make a reasonable return. So I think that piece has become a bit clearer for them.

I think also some of the concern about in terms of your legal entity booking model – and one of the challenges with global banks is they have tended to book across border into a particular location and that has caused all kinds of challenges. Now, I think the challenge has become how do you do that when you don’t know how regulators in different countries might react? I think that some of the firms are starting to work through that and say, rather than worry too much about that, we know we want to be in major financial locations where we think we have a good understanding of what the law is that we operate our business under, and where our counterparties will be comfortable contracting with us. And then we will book our business into an entity in that location and deal with the regulator there.

I think some of what we see in Dodd-Frank and what's happening around OTC derivatives is forcing that change as well. So that has helped to clarify people's thinking a little bit. But it still is not over. And I think one of the things that is frustrating for all of the banks is that they don’t have clarity about how some of these regulations are going to be applied. Maybe 2011 is the year where that does get a bit clearer for them.

Knowledge@Wharton: Marcel, within Europe, because there are some European institutions that try to impose a little bit more order, is there a little bit more clarity about at least what the environment within Europe is going to look like?

Marcel van Loo: Well I think my view is that there is over-capacity actually in the banking market in Europe. Also I have to say, except maybe for investment banking, there is maybe not such a thing as a European banking market
like a retail banking market. I think what I see developing over the next couple of years is sort of this category of regional banks with a very strong retail franchise in the various countries – not so much global – and I think they are very close to their customers. And I think they are well positioned to offer services also not only core banking services, but private banking or asset management. So I think that is a clear trend, which I can see developing. And maybe they are in a much better position because contrary to the global banks they don’t have to fulfill all these additional capital requirements. So I think also a return to their shareholders they will be quite successful.

In order to get a better working European banking market I think we look at basically the politicians – the leadership -- and in the eurozone crisis that we are in, I think, that's the only way out. I can see that it will take some good leadership to lead the way out of the crisis. I don’t think it's a real economic crisis as such, but it is more like a leadership crisis and a reform of the eurozone to create a more European banking market.

Knowledge@Wharton: So it sounds like there are concentric rings of complexity and uncertainty. So if you are operating nationally you are on a little bit firmer ground or let's say in your national branch you know what's going on and you are – at least regionally you have a better sense. You may not know how Dodd-Frank is going to affect you, but you know that maybe some eurozone rules will affect you in certain ways – a little more clarity – maybe a little less around Basel III. And then when you are in a position of having to think about ‘we’re operating globally, we are in Asia Pacific, Europe, Latin America and so forth, that's when – Mauro, maybe I’ll let you sum that part up.

Mauro Guillen: Well, it’s true. Well, let me just speak to this point because I think it is a very interesting one, which is this: Is a local bank now in the midst of all this uncertainty better off than a global one? So granted that the regulatory environment is uncertain. We don’t know how it is going to be implemented. Then when it gets implemented you don’t know to what extent actually they are going to watch you and force you to comply with whatever new regulations come into play and so on. But let me perhaps say something more optimistic, which is that for the global banks – for the ones that have sprawling businesses in many different countries.

Precisely in the times of uncertainty that is when being present in many different segments of the market, having different businesses and different geographies is valuable. Those are real options. Real options – financial options in general are more valuable when there is uncertainty. A local bank may not have to deal with all of those complexities but it is stuck in that market. If that market doesn’t grow – and there are plenty of them in Europe that are predicted not to grow – then you are stuck there and you don’t have other options.

So I would actually like to sound an optimistic note here on the global banks. They have options. Now, as Ian was mentioning, they have to make decisions. “Do I stay in this business? Do I get out? Do I go into this new market? Do I get out? Do I make an acquisition here or there?” They are going to have to make decisions to be sure. They cannot stay still. But I think they have a range of options, which a purely local bank – one that is in just in one line of business and one country, perhaps, has a lot of branches but is limited (in its options). What if that country – that economy – doesn’t grow? It is going to be tough for them. So that would be my optimistic view of the complexities facing the truly global and diversified and complex banks.

Knowledge@Wharton: To take it one step further, does that mean that banks that are able to make decisions faster are going to have an advantage?

Mauro Guillen: Well they are going to have to.

Knowledge@Wharton: Or everyone is just going to have to?

Ian Baggs: That’s when you see opportunity, then people who can see that and make a decision – probably not just make the decision – but it is the speed to which they get to market becomes very crucial. So they are connected and have the ability to invest quickly – have the right talent focused on the right things in that location.

Mauro Guillen: And that goes back to the technology by the way. The technology may enable them to move fast. One thing is that the top management team says that we are going to do this. But then is the organization going to be able to follow?

Knowledge@Wharton: Can you execute?

Marcel van Loo: Execution.

Mauro Guillen: Exactly. Quick execution.