

Five Forces Shaping the Banking Industry

Preparing for the economic recovery



After months of turmoil, the banking industry is starting to show signs of stability. In their struggle to survive, however, many institutions turned their attention away from certain forces that are shaping the economic landscape—and to which banking institutions must respond. A.T. Kearney believes that addressing these forces will be critical as the economy stabilizes and begins its upturn. As banks prepare their strategic agendas, the focus should be on five major forces.

As all signs point to an economic recovery, the banking industry is working diligently to restore capital and profitability. The best banks are becoming future focused—striving to meet the unique needs of a new breed of customers while also dealing with the inevitable new regulations. True success in next-generation banking will go to those prepared for five forces that are shaping, or reshaping, the industry. This paper highlights all five forces and outlines the key ingredients for success.

1. The New Bank Customer

There will be profound changes in consumer and business profiles over the next decade. Demographic, social and technological factors will fragment customer needs, tastes and preferences. As people live longer, travel more and work and play “virtually,” banks will not only have to manage their costs, but also refine their value

propositions and service concepts if they are to compete effectively (*see sidebar: Thinking in Customer Segments on page 3*).

As banks look for ways to design specific products and services to address these changes, packaging, labeling and category management will become crucial. Diminished public confidence in the banking system will force banks to re-learn how to communicate their service offerings and restore consumer confidence.

How can banks serve these various segments profitably? Tailoring products and distribution to each segment will be difficult and expensive, as geographic boundaries will fade. Even with the Internet, it is difficult for banks to operate outside their home countries. What choices must be made?

Consistency. A consistent approach to defining product offerings, channels, brands and cost-efficient delivery will be essential. Banks will

have to satisfy dozens of customer segments from a single product “factory,” much like the automotive industry does as it serves multiple customers with different vehicles built on the same platform.

Flexibility. Flexible delivery will be essential. For example: Can a retired British civil servant living in Spain pay his bills from his British account? Can a college savings account be fed by monthly allowances from two accounts in different countries? We believe banks will have to bundle existing accounts into packages tailored to meet such specific needs.

Information technology. All of the ideas discussed so far can be realized, but they require the right IT infrastructures. Banks in Australia, Canada, Germany and the United Kingdom are already radically overhauling their core banking systems to handle many more product variants.

Branch banking. While the Internet will be a dominant channel for transaction banking and investment decisions, more complex customer needs will still require some form of local branch office. New models are already emerging in Europe and Australia. These branches do not handle cash or valuables, but rather they serve as a kind of “foyer,” with ATMs to handle cash transactions, laptop computers to initiate services, scanners to process required documentation and printers to produce necessary paperwork.

Although bank employees are present in these bank foyers, they operate more in the role of “financial butlers.” Business hours are flexibly geared to early morning, lunchtime and early evening peak traffic. With the elimination of cash, the atmosphere has transformed from a secured, limited-access environment to one that is open. During low-traffic periods, staffers can visit elderly customers who have subscribed to a home-delivery package. This is what new-generation retail banking looks like.

Brands and service models. We believe that brands will keep their unique identity but will need to be associated with emerging communities. One customer segment may need an affiliation with social networking brands (such as Netlog), while another may need to be associated with a care provider. It is unlikely that a single brand will be able to cover all segments.

When discussing how this might work, we ask our clients to envision a retail bank with a single global brand supported by multiple format brands. We point to Club Med as a good example. The Club Med resort offers family-, sports- and singles-oriented concepts, even differentiating with special cruise offers. Everything resides under the Club Med banner, with a unique concept for each customer segment. Applying this to banking, there might be a concept for customers who want their bank to be based on Islamic principles. There is another concept for young people who want instant gratification (as is the norm with iTunes) and still another for older people who may be more interested in home delivery. Mixing these different service models will require some skill and may seem daunting at first; however, such mixing has been practiced for years by booksellers and by restaurant chains that provide take-away meals and in-house seating. It is not that difficult.

In short, the best banks will set up specific service delivery and channels for each segment, and track cross-channel needs and preferences, without adding cost.

Banking on business. As the economy evolves, businesses will also face new challenges. Many companies have already leveraged existing credit lines and hoarded cash, postponed investment and trimmed their workforce. Stock-market valuations may favor mergers and acquisitions. Confidence in the banking system is at an all-time

Thinking in Customer Segments

A host of demographic, social and technological factors are changing bank customers. The best banks are adapting their practices to address these unique needs and preferences.

Centenarians. The segment of people age 100 and older is growing significantly. On a broader scale, people over 80 years of age comprise 3 to 5 percent of the total population. This segment is growing at a rate far higher than the overall population. Although often restricted in mobility, they still have basic financial needs such as assistance with planning and budgets, purchasing long-term reverse mortgages, and advice on distributing their estates.

Traveling students. The number of college students participating in exchange programs abroad has doubled over the past decade and now exceeds one million. While abroad, they likely receive allowances or may get a job, but retain their primary bank in their home country. But, what are their options should they want to buy a car? How can they get a loan without a credit history in their new country?

Migrant workers. Many countries' labor shortages result in an influx of migrant workers who regularly send money home. This income represents a significant part of some countries' economies. These workers typically face language and cultural issues in their destination countries, and seek communities of their countrymen. In the Western World, for example, Muslim immigrants make up more than 15 percent of all inhabitants. In the United Kingdom, the Muslim population grew at a rate 25 times

higher than that of the overall population between the years 2001 and 2008. In some Western countries, the banking industry has begun to adjust: Turkish banks have emerged in Germany to serve Muslim customers, while the government of France has changed certain laws to eliminate tax disadvantages associated with Muslim-oriented banking.

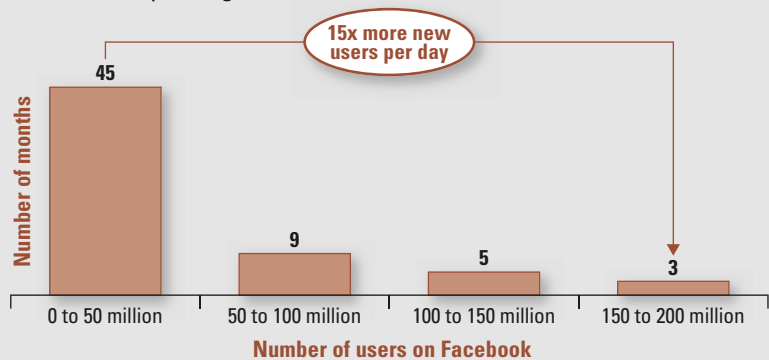
Virtual communities. The number of Internet-based social communities (such as Facebook) has increased exponentially in recent years, and following closely are efforts to create personal-lending websites (*see figure*). Although early initiatives may prove sensitive to fraud, we could see secure virtual investment banks that focus on dynamic, connected groups of young entrepreneurs. Facebook has begun experimenting with this kind of peer-to-peer lending.

"Happy inheritors." Whenever the average number of children per family drops below two (1.7, to be precise), inheritance concentrates wealth. In

Europe, average fertility rates dropped to 1.5 in 2000. Family Office and Optima are two specialized advisers that have begun assisting in succession planning and the like, often moving assets around among products and financial institutions. Significant assets are likely to be involved.

Non-traditional families. The divorce rate in OECD countries is at about 50 percent, and many young couples are opting for alternatives to marriage. Increasingly, people are engaging in serial stable relationships, with newly composed families that lead to particular needs. For instance, a middle-aged person may live in a household with stepchildren, and have various support payments coming in and going out. In many countries, legislation protecting savings for children and their education has become quite complex. Household budgeting, especially combined with the growing trend of flexible employment arrangements, is also an issue with which banks must learn to deal.

Figure: Participation in virtual communities such as Facebook is exploding



Sources: Inside Facebook; A.T. Kearney analysis

low. No longer can banks be guided by historical patterns—they’ve become obsolete. Thus banks must take a segmented approach to developing new service models for the corporate market. The following are brief discussions of what the future might hold for key banking functions.

Credit. The role and function of credit is changing dramatically as different trends affect different market segments. With more electronic transmission of business documentation, we believe a more efficient lending system may well follow.

While many banks and corporations have watched their credit ratings drop, many of the large, fiscally conservative corporations continue to retain their AAA ratings. These corporations should be able to self-finance in the capital markets. Indeed, 2009 has seen increased financing of

these corporations in the bond market compared to 2007, when overall credit volume dropped by as much as 30 percent (see figure 1).

Meanwhile, firms that once enjoyed a satisfactory investment grade rating are now rated below the investment grade bar (see figure 2). This raises their funding costs, at the same time increasing the capital needs for banks to fulfill these loans.

Shortening the balance sheet. As medium-sized companies lack access to capital markets enjoyed by large corporations, there’s been huge growth in leasing and associated businesses that require less capital. This evolution may eventually reach intangible assets such as intellectual property and brands, which in turn can be leased to raise cash. Because this is a new concept, well-thought-out risk management will be critical.

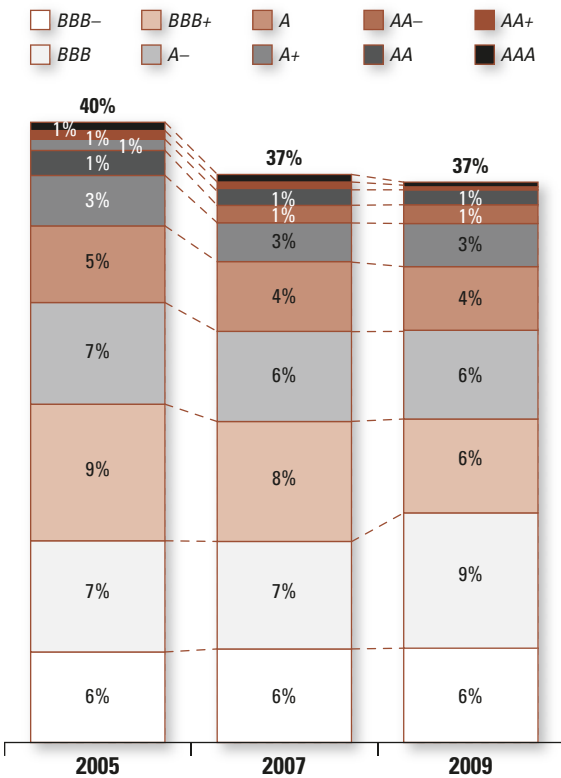
Figure 1
Bonds comprise a larger percentage of global debt



Sources: Thomson Financial; A.T. Kearney analysis

Figure 2
 Number of investment grade corporations falling

Credit rating¹ distribution for investment grade corporations
 (% of rated companies, 2005-2009)



¹Long-term local issuer rating from Standard & Poor's
 Sources: Bloomberg; A.T. Kearney analysis

In addition, companies have been outsourcing workforce benefits, such as pension provisions (typically to insurance companies), and factoring in accounts receivable. Add stock financing or leasing to the mix, and a corporation could end up with a balance sheet showing only a few line items—cash on hand being the most important (see figure 3 on page 6). This would support return on equity, provided the lender's cost of funding is lower than the borrower's. Indeed, specialty

finance, comprising leasing, factoring and other item-related products, could well become more than a cottage industry.

Ecosystems as a segment. Businesses have been coalescing into networks that supply each other, much like nature's ecosystems. The automotive industry introduced the concept, and the apparel and other industries have followed suit. These ecosystems actually operate as virtual conglomerates, linked by strong information backbones. RosettNet in the high-tech industry is an example. Animated by Intel and Nokia, suppliers exchange production and ordering messages electronically using a special protocol, and they are able to orchestrate a highly efficient supply chain. We think it's only a matter of time before this ecosystem begins organizing tenders for banks to bid on financing or cash-management services. Few banks will be able to cover all services, however, and a banking consortium may be needed. This, in turn, could create a new breed of correspondent banking.

As noted in the sidebar *From Invoice-Discounting to Working-Capital Financing* on page 7, this scenario may be a blessing for banks. Getting deeply involved in working-capital finance may reduce the total credit exposure in a supply chain, lead to better use of banking capital and minimize risk. In an era when most banks are trying to reduce the leverage on their balance sheet, this would be most welcome.

No more paper. Many countries have standardized electronic identification numbers and supplemented them with digital identification and signature powers. Leading global firms such as Johnson & Johnson already invoice electronically. This is forcing banks to rethink their service models and offers opportunities for new services, such as the handling of accounts receivable and payable. Transaction banking could eventually

become fully electronic, with a product supply mirrored by a financial supply chain, and with components and assemblies paid for immediately as they move through the chain.

All of these possibilities raise interesting questions for the banking industry:

Which “ecosystems” should we back? Banks must determine whether they have the skills and the distribution footprint to become the financial supplier of choice. They must also consider their ability to implement the technology that will help gain true visibility in the ecosystem.

What digital real estate should we occupy? As purchase orders, invoices and payments become fully electronic, banks must determine which service they can offer immediately, which they can develop and who will be the likely competition. (Could Google become the next bank?) Banks

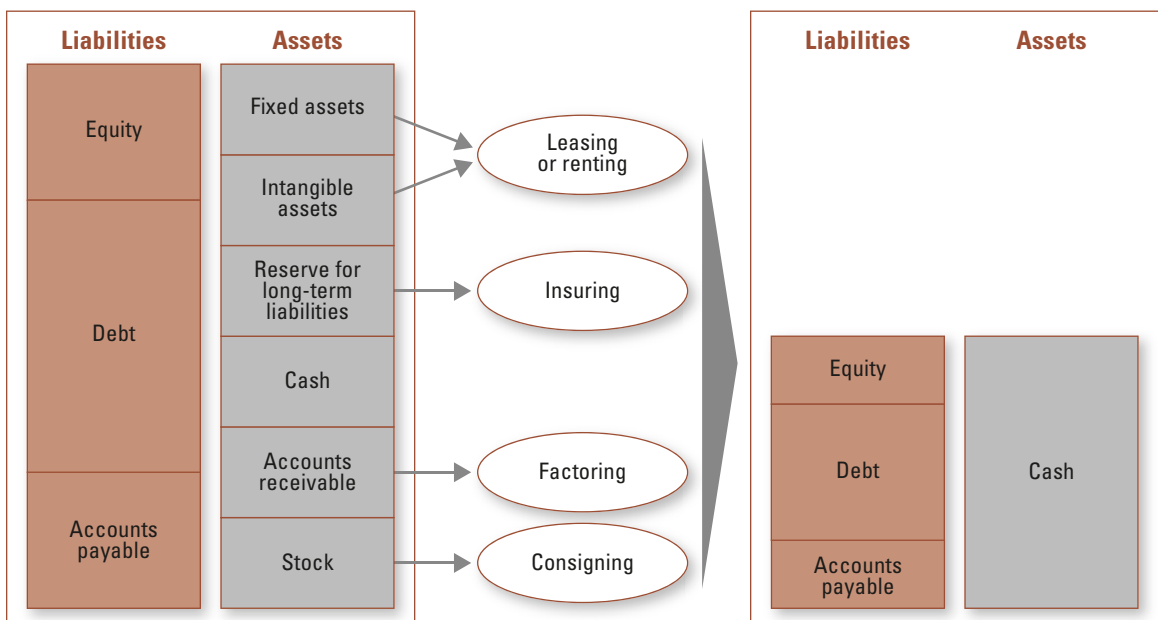
must also think through the roles of postal agencies, couriers and other logistics partners.

How should we think about credit? In the aftermath of the current financial crisis, business practices will change drastically due to greater regulation and increased industry stoicism. Banks will have to help companies shorten their balance sheets without lengthening their own. With securitization markets currently frozen, this will be no easy task—but in the longer term, advanced syndication may prove beneficial.

2. Supply: Where’s the Money?

How will the economic downturn influence supply in the financial-services industry? The answer depends on the industry’s structural changes and competitive intensity, and on the way institutions bring products and services to market.

Figure 3
Corporate balance sheets are being outsourced



Source: A.T. Kearney analysis

The following are factors to consider:

Optimal size. The current crisis has taught us that no bank is too big to fail. The deeper issue is whether society is better off with a group of specialists with optimal size reducing risk by containing it in manageable parts. Hypo Vereinsbank, Crédit Lyonnais and others were saved because their home country's government was big enough to embrace them. The problem with AIG was different, with much of its \$140 billion rescue package immediately spent on meeting counterparty obligations. However, regulators may encourage—if not enforce—an optimal balance-sheet

size, which may trigger restructuring. A version of this already exists in the United States, where no bank may carry more than 10 percent of savings on its balance sheet.

Given the obvious trend toward globalization, certain banking activities will need an international footprint. But remember: When business choices lead to presence in a certain country, cultural and managerial challenges follow. Can your bank deal with them in a cost-effective way? Another global factor to consider is the very real possibility of Chinese manufacturers taking over some of their Western competitors—and whether

From Invoice-Discounting to Working-Capital Financing

Invoice discounting, factoring and forfeiting provide businesses with cash. The technique, which transfers corporate invoices to banks in exchange for cash, is beneficial, especially for startups or companies in receivership. However, it can consume a lot of capital when applied on a larger scale. As supply chains become longer and more fragmented, the total amount of potential credit in the chain grows to a multiple of value-add. In times of crisis, the amount of capital needed as a risk buffer also grows.

There is a better way. More supply chains are becoming “ecosystems,” as exemplified by RosettaNet in the high-tech sector. Since all suppliers exchange information electronically, the banking community could internalize its working-capital function by buying invoices sent and invoices received, paying the customer the value-added minus a fee. From invoice discounting

or factoring, the system moves to value-added financing.

The counterparties are essentially banks. When done systematically across the supply chain, this can reduce risk as banks usually have a better rating than the corporations involved. For example, if one supplier goes bankrupt, the financial chain, now totally absorbed by the banking system, can continue. This also works if one company has multiple suppliers, or if there is no one-to-one relationship between invoices payable and receivable in terms of business partners. The only issue arises when a business is building up large inventories, and accounts payable could exceed accounts receivable. This would lead to a negative value-added, and the concept would break down.

To take this a step further, imagine a single bank taking on the financing of a supply chain. While this may seem ambitious, the economic logic is that the amount financed becomes less or

equal to the value-added, as accounts payable and receivable balance out. This increases system efficiency, as the residual risk is the credit risk of the chain's last element. To produce and finance the same amount of goods, far less credit and capital is needed. In other words, this could be a win-win proposition for all parties.

A skeptic would say this is prohibitively difficult (since few banks enjoy customer relationships that involve value chains so deeply) and would be incompatible with the current market practice of factoring invoices and reducing risk. But with business ecosystems such as RosettaNet that employ electronic invoicing, the concept is relatively straightforward.

Although the invoice-factoring concept requires orchestration and significant investment, electronic invoicing is a mechanism for providing liquidity and reducing working capital in a cost-effective manner.

this will require a presence in China for those Western firms' banks.

In addition, many banks are returning to “narrow” banking, using a retail deposit base to fund a retail and corporate credit function. ING, for example, announced that it will cease operations in 10 international markets, while KBC plans to discontinue all non-core activities. Banks are again embracing transformation risk as a key profit driver, probably assuming additional interest rate risk while reducing funding needs (and, therefore, liquidity risk).

Competitive returns are needed if the banking industry is to be viable. But until the fog surrounding credit losses lifts, it will be difficult to ascertain the extent of those returns.

Finally, banks may be forced to do some severe product pruning, especially if activity is geographically capped. New IT tools to optimize price sensitivity may help in this exercise.

Limits of generic risk buffers. The argument for separation of banking activities is the forced break-up of correlation. Unlike the insurance business, equity in banking is a generic risk buffer covering all activities. But doesn't this “genericness” increase correlation? Simply put, if the dealing room incurs an excessive loss, the risk buffer can also be eliminated for mortgages. For example, Lehman Brothers, a traditional investment

bank, was a de facto hedge fund broker, dealing for its own account—a risky combination. A bank's proprietary trading can take a different position from that of its brokerage arm in advising customers, as exemplified by Goldman Sachs. The result is that customers are left confused—to say the very least—about the quality of advice they are getting.

The promise of Allfinanz. Combining banking and insurance was once roundly applauded because of synergies in distribution, product development and asset or liability management.

American bank financier Sanford I. “Sandy” Weill embraced Allfinanz to realize an old dream: acquiring Citigroup. But almost as soon as the deal was done, he sold Citigroup's insurance business, because distribution synergies proved to be real in life insurance but not in property and casualty. In another example, bank insurer ING has

already separated from its P&C insurance arm.

As for Allfinanz's long-term future, product synergies could be achieved through outsourcing and lead to faster product development, but the benefits are limited. In assets and liabilities, real synergies may be elusive. Life insurance typically invests with a five- to seven-year duration, while liabilities have a 10-year-plus duration. In banking, assets have a three-year duration, whereas liabilities last about a year. In addition, the size of a bank's balance sheet is substantially greater than that of an insurance company, and the efficient swap market is a good alternative to

hedging interest-rate risk. Again, there is limited benefit here.

3. Banks: Under New Management

Regulators are rethinking their monitoring practices, and this could lead to new accounting standards, capital adequacy and even the restructuring of the entire financial system. The focus is on several areas: limiting mark-to-market accounting practices, despite their advantages in times of high liquidity; determining capital adequacy of credit and liquidity provisioning; and allocating capital to different banking areas. But the focus may spread further. Regulators could demand online and confidential access to the risk position of every

supervised situation, thereby creating a “heat map” as risk builds. They could then claim the right to limit certain risk positions.

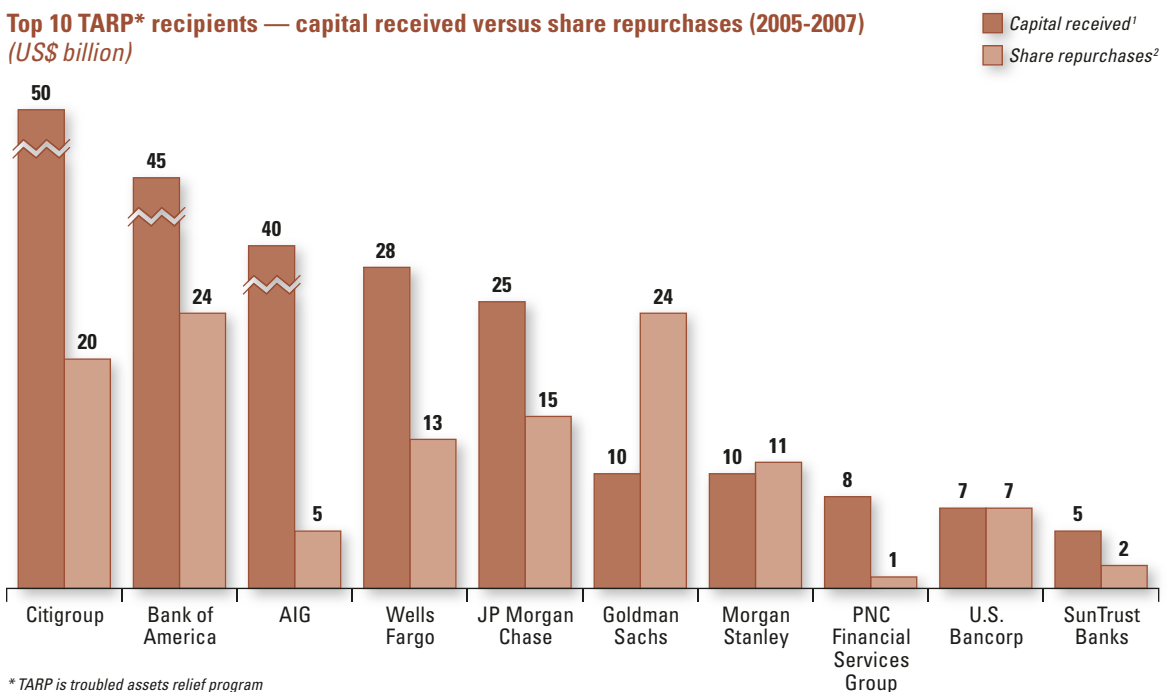
Here are other forces to consider:

The volatility trap. As many securities are mark-to-market, a single incident in a low-liquidity market could provoke major valuation swings. The longer the duration of the security, the more likely it is that the holding period will be long, and that the swings could drive large variations in banks’ value. Smoothing the valuation by averaging pricing over an agreed and relevant period may help combat volatility.

Share buybacks. Financial suicide? In the past three years, virtually every bank engaged in buying

Figure 4

Virtually every bank has repurchased shares



* TARP is troubled assets relief program

Notes: ¹Capital received as of April 15, 2009

²Share repurchases are displayed at historical purchase amounts and costs

Sources: Companies’ annual reports; U.S. Department of Treasury; FinancialStability.gov; A.T. Kearney analysis

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back shares, thereby effectively reducing capital (see figure 4). Now these shares are either destroyed or held in treasury, therefore capital is reduced. Goldman Sachs bought back \$24 billion in stock between 2005 and 2007, while it has received \$10 billion in government aid over the past six months.

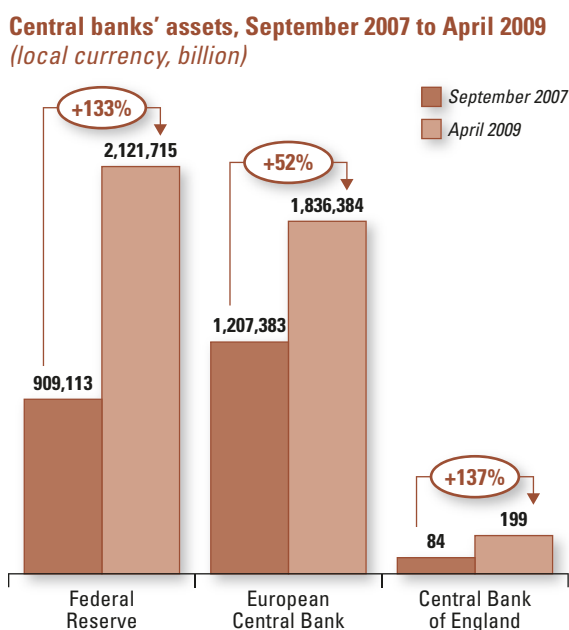
The government “shareholder” acted as a lender of last resort to compensate for huge capital losses incurred by banks. But is this good for innovation and growth? Is it really the best use of taxpayers’ money? Some answer these questions with a resounding “No,” while others say such a move opens a perspective to structure for the benefit of society. Government can generate wealth, depending on ownership terms and the arrival of economic recovery. This wealth could be partly reserved as a risk buffer, or used as an investment vehicle for long-term societal goals, such as investment in alternative energy. Banks, on the other hand, appear eager to repay government loans as soon as possible, and to free themselves of restrictions that came with the support.

Central-bank balance sheets—landfills for toxic assets? The current issue with central banks is whether they should buy up so-called “toxic assets.” This has led to debate about how far they should go in fulfilling their purpose. The U.S. Federal Reserve System and the European Central Bank have chosen completely different strategies; this debate is likely to be long and public. What isn’t subject to debate, however, is that both have seen their balance sheets grow as they’ve battled the financial crisis (see figure 5).

Regulations will become tighter—oversight of hedge funds, for example—and focus especially on preventing more Madoff-style schemes (see sidebar: *The Sky May Not Be the Limit, But It’s a Source of Inspiration*).

There’s also the question of how an activist government should view its ownership. Government interventions range from guarantor to stockholder, and we believe governments should think

Figure 5
Balance sheets have become landfills for troubled assets



Sources: Central banks’ balance sheets; A.T. Kearney analysis

through the results of their participation. They could resell when the economy recovers, or use their participation as a starting point for a risk buffer against future crises. This idea has appeal, and it could be a complement to or even substitute for forcing banks to hold more capital. At the end of the day, however, financial markets will require competitive returns, and excess common

The Sky May Not Be the Limit, but It's a Source of Inspiration

With about 25 percent of all national wealth having evaporated in the current financial crisis, regulatory frameworks warrant a thorough review. Hawkish activists call for a global regulator, while more pragmatic observers see the difficulties of international agreement when speedy domestic recovery is the prime concern of every elected official. And while free-market advocates abhor any intervention, they would not dream of boarding a plane at O'Hare Airport after a public announcement that air-traffic control is being replaced temporarily by Adam Smith's invisible hand.

Indeed, the aviation system on which we all rely for safe transportation can be an inspiration for a new form of global financial regulation. Similarities exist in at least four areas:

Allocation of responsibility. Air-traffic control has dealt with this in a pragmatic way. Each country controls its own airspace, and international organizations handle the airspace between nationally designated zones. Because of this, all pilots know exactly when and where—and to whom—to listen without the oversight of a global authority. In other words, there is no global regulator; it is sufficient to have agreed-upon standards and procedures and to allocate the territory. The latter has also been true for the financial industry: Current regulations

follow the principle of sovereign territory. Subtleties exist, as in Europe, where directives are applicable to Euro payments to be ratified in all countries of the European Union, but such deviations are managed effectively without a global regulator. Internationally agreed-upon standards, practices and procedures may be all that's needed.

Minimum safety standards. Each commercial or private aircraft is subject to rigorous inspection at predefined intervals. Missing documentation or suspicions of malpractice may prevent entry into a particular airspace—or even ground an aircraft. In the banking industry, it could be sufficient for regulators to define the tolerated risk level of a financial product and deny distribution rights in case of missing documentation or unacceptable risk level. This does not mean that all countries need to apply the same rigor; they just need to agree on common documentation and language. Any regulator can decide what to allow in local banking “airspace,” depending on the desired level of investor protection.

Common language and procedures. Any pilot knows to speak English over the radio and use the internationally accepted phonetic alphabet—for example, Charlie Delta Sierra—to communicate important information. This could be inspirational to banking regulation. Think about accounting or vol-

untary regulatory frameworks such as Basel II. Regulators could collaborate with existing organizations to define international financial “traffic control” signals. This would probably mean a calibration of existing ratings, and perhaps the creation of additional ratings based on prospectus appreciation. In the airline industry, planes are not allowed to leave a departure gate if there's congestion at the destination airport. By way of an analogy, a national regulator could close down a certain asset class if he deemed risk was piling up in an unacceptable way—much like planes would pile up on a congested runway.

Real-time management. Radar is essential in today's crowded airspace. But crowded global financial markets have no “radar.” Yes, there is periodic reporting, which may help assess long-term solvency; however, this does not help in sudden liquidity crises. It is relatively simple to construct the financial equivalent of radar. It is sufficient to have a bank or hedge fund declare its position in real time to a regulator. Just as air-traffic control is not accessible to the public, real-time observation by regulators would be confidential, so there is no need to worry about position disclosure. A real-time risk “heat map” could allow regulators to coach institutions in danger discreetly, and help them wind down positions in a timely, efficient manner.

stock may hamper adequate returns, making it difficult to attract capital. The availability of a rescue fund, with for-fee drawing rights, is more than a bit interesting.

What is the long-term impact of central-bank actions? The Fed and the Bank of Japan have bought toxic assets, and the ECB is considering a similar move. Buyers need to understand the long-term impact of this trend. It could depress the value of the dollar, for instance, and this, combined with a burgeoning Chinese economy,

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could create a huge value discrepancy between the dollar and the Chinese yuan, or renminbi. The result could well be that the Chinese may be tempted to follow the U.S. Congress’ appeal to “Buy American” and do just that: Bid for large American businesses.

4. Technology and Infrastructure

In information technology and infrastructure—covering such functions as exchanges, clearing and settlement—improvements have yet to be made fully, so there are numerous opportunities for cutting costs and upgrading capabilities in this area. The process of opening accounts is still

largely a manual one, and mandate management still involves extensive paperwork. It’s telling that in countries with high penetration of broadband Internet, up to 80 percent of bank customers use online banking. Law-making bodies can be catalysts for IT change by mandating or offering incentives to handle bank documentation electronically. But the industry must act on other factors to take full advantage of IT’s potential.

Killing legacy systems. In the 1970s, banks were among the first to embrace IT, but they are now handicapped by the costs and risks of maintaining myriad legacy applications. Modernizing these infrastructures could cut costs significantly. (It has already done so in credit-card and mortgage processing and payments.)

The financial crisis offers an opportunity to revisit IT and learn more about proliferating access points and service methods. Young people, for example, prefer text messaging and online chatting; business professionals are likely to opt for email; and older people still prefer the personal conversation. The delivery of financial products and services should be tailored to these various segments.

Emerging markets. New markets are likely to emerge to reduce risk. One possibility is a central counterparty to clear over-the-counter credit and derivative transactions. A similar initiative could be introduced to avoid excessive gross positions in “swap” books. Similar to the novation process in equity trading, a swap could be cleared by a central counterparty, avoiding unnecessary build-up

of gross positions that hide behind a small net position. This would reduce counterparty risk and ensure faster settlement. This approach has to be international, with clearing covering major sub-markets in a given region.

Obviously, any new regulations regarding IT upgrades will mean significant investment for

banks. This will be daunting. It may be worthwhile to consider an apt metaphor for changing complex, interwoven structures: Urban planning. Applying the principles of urban planning may provide insight to handle such a complex task (*see sidebar: IT Renewal and the Analogy of Urban Planning*).

IT Renewal and the Analogy of Urban Planning

Improving a complex set of legacy IT systems is similar to renovating a medieval or historical city. Banks were among the first to turn to IT, but are now suffering from the constraints of this early investment because they have not upgraded sufficiently. Comparing IT renewal with urban planning contains such value, in that everything cannot be changed in one fell swoop. Priorities must be set and choices must be made, but sometimes well-handled parts lead to an unsatisfactory whole. Just as people continue living in the city that's undergoing urban renewal, IT systems have to continue to support the business while being upgraded. Six principles clarify this:

Clear functional choices. Urban planning implies a clear allocation of functions based on insights. Some modern sports facilities, for example, are situated in the outskirts of a city, not in its downtown district, as with the Arena soccer stadium of Ajax Amsterdam. Similarly, there are a number of new insights that drive modern banking architecture: A single business partner module, a central product data warehouse, and a financial-event warehouse where each event is logged, so that a single source feeds different valuation

tools for various reporting or risk-management purposes.

Tight governance. Paris is the example that comes to mind. In the 19th century, the city center full of narrow alleys was transformed into a geometrical pattern with wide avenues. City leaders implemented this vision with a firm hand, ignoring the protests of various interest groups. For banking IT, this lesson of Paris' urban renewal is that important choices are needed regarding the governance model, the strategic suppliers involved and the procedures to authorize deviations. Discipline is of the utmost importance.

Long-term vision. In 1900, Moscow implemented a visionary subway system that still serves the city, although it has expanded many-fold over the past century. Similarly, some banks are implementing IT systems that can launch new products in days, rather than months. They are vigorous in respecting the choices that have been made to implement these systems, at the same time carefully selecting their partners, managing them well and sticking with them.

Accepting start-up costs. This was the case with the London Docklands, which almost went bankrupt a few

years after completion of the initial tower, but later became the new financial center of London. Similarly, writing codes designed for re-use requires 30 percent more time in design and coding. It is hard to maintain this investment when the business is under pressure to perform better, but those who have accepted start-up costs have reaped the benefits. *Crédit Suisse*, for example, now has a service called "get account balance," which is visited about 100 times every second!

Execution matters. The Los Angeles Olympic Games were the first Olympic Games to register a profit, thanks to a flawlessly executed merchandising and sponsorship plan. Similarly, excellent planning, good supplier management and active control of a risk register are the three necessary ingredients for proper IT renewal.

Timing. The cities of Barcelona and Munich reduced their social housing needs by re-using their respective Olympic Villages as affordable housing. Similarly, many cooperative banks, which are not affected by the financial crisis, are continuing—and even accelerating—their efforts for IT system renewal.

5. Performance: Making Profits

We now come to the fifth—and perhaps most important—force that will shape the banking industry in the future: performance and profit. Questions arise immediately. What type of profits can be expected over the next few years? Is profit potential attractive enough to secure access to capital? Should governments allow special tax breaks for banking?

The answers aren't so easy. So far, it is still not clear what type of profitability can be expected. As the economy recovers, additional capital requirements could dampen returns, thereby rendering

The banking industry must develop well-thought-out initiatives to manage both talent and money if prosperity is to be restored.

the sector unattractive for investors. What we're seeing now is a long-term mortgage on the soundness of the banking system. Competitive returns are needed if the industry is to be viable, but until the fog surrounding credit losses lifts, it will be difficult to ascertain the extent of those returns.

We can say that the industry's first-quarter results were encouraging, though they were driven largely by the financial markets and, some say, accounting deviations. We also believe the industry has to think about its long-term appeal as an employer, particularly with regard to executive positions. While hefty compensation was a magnet for talented executives, many turned out

to be ill-prepared to lead the way through the financial crisis. Regulatory compensation capping may be unavoidable, but we think it's ineffective. Nonetheless, the banking industry must rethink how best to attract and develop people with leadership abilities, particularly since many current executives may move on earlier than planned.

The industry must also face pricing changes. We think there may be a shift in pricing levels for different functions. Credit will come at a premium, with higher margins; and deposits may become a temporary loss leader as banks try to maintain stable funding. As volatility increases, trading and derivatives could become tempting (albeit risky) activities. In any case, the profit mix may shift dramatically, and banks need to figure out how to deal with it.

There's also the question of how government intervention will affect the economy. For example, will what some observers call out-of-control government spending spur inflation? Ironically, such a scenario could have an upside, as house prices would likely also rise, thus allowing homeowners to service their mortgage debt. On the other hand, differences in inflation around the world could distort trade balances, further fueling disenchantment with protectionism.

Finally, there's the well-publicized question of executive compensation. We believe the banking industry sector can—indeed, must—offer compensation and incentives that will attract and retain solid leaders. Furthermore, banking executives should be compensated on the same order of magnitude as those with whom they deal, perhaps

through long-term vesting of variable compensation tied to long-term risk-taking. There must be this kind of equilibrium in compensation.

Restoring Prosperity

We will close by noting that there is a legion of serious bankers trying to strengthen the industry. While they are trying to restore capital and profitability, their customers are rapidly fragmenting

into new, unique segments with new needs that require capital investments. Inevitably, increased regulation will require more investment. The banking industry must develop well-thought-out initiatives to manage both talent and money if prosperity is to be restored. Segment specialization, IT upgrading and transforming into leaner institutions are among the key ingredients for banks to succeed in the not-so-distant future.

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