Four Horsemen of the (financial) Apocalypse

Introduction

The Four Horsemen of the Apocalypse, have captured the imagination of many, including academics, artists, writers and movie producers, and are symbolic to many as the harbingers of impending doom.

There are many interpretations as to what the Horsemen represent and although there are differences in most accounts, the four riders are most often seen as symbolising: Conquest, War, Famine and Death.

Of course, the Four Horsemen imagery has also been used to label other aspects on the horizon that represent a threat to humanity and the world in which we live. Following in the footsteps of that practice, it is worth considering the Four Horsemen that are charging over the horizon towards our financial institutions.

Rather than Conquest, War, Famine and Death, financial institutions have their own Horsemen that threaten them and our domestic and global economies:

Consumerism

Technological investment in the preceding decade has led to greater customer choice and control. The easy access to information and increased transparency of performance versus promises will see financial services providers held much more accountable and consumers increasingly moving their business.

Regulation

Increased regulation from several organisations domestically (Bank of England, Prudential Regulation Authority (PRA) and the Financial Conduct Authority (FCA)) and internationally, as well as the fines and penalties they can levy to organisations that they deem as non-compliant.

Competition

Specific customer groupings and elements of the value chain are being targeted by newer players that have bespoke business models that have advantages in terms of lower cost bases and a lack of legacy issues.

Obsoletion

The opposite of Futurism or investing in science & technology, and the failure to safeguard the future leads to long term decline that cannot be reversed.

Consumerism

Financial institutions are renowned for their expensive marketing campaigns that make big proclamations against a catchy backing track. "By your side", "we are what we do", "make money work for you", "taking on your future together", "it's a people thing" and "helping you achieve your goals" are easy to state and seriously hard to actually fulfil. Memories are long when it comes to consumers who were sold products they didn't really need, or promised returns on policies and pensions which then failed to materialise.

There has been an acceleration in digital adoption and for many, this is the way we shop, catch up with the news and access entertainment. With this control comes choice and people have greater access to information, goods, and services that fulfil their self-identified needs from the institution that best meets their criteria. The rise of consumerism may also mean that people recognise when their interests are not being served and are more sensitive to promises that seem inauthentic. Past apathy to moving supplier, or the feeling of being stuck, will be replaced by freedom and enablement. In future, over promising and under delivering may be catastrophic for financial institutions.

As banks close their branches and withdraw services to save costs, then blame it on their customers' change of behaviour, they may be guilty of misrepresentation. The pandemic has also shown the need for smart escalation routes and the importance of human contact when a customer deems their issue to be complex or high value. In the past, customers have been remarkably 'sticky' but with consumerism, customer loyalty is not guaranteed. Worse still, institutions may not be immediately aware of the consequences as their customers are unlikely to close or transfer their accounts but instead stealthily divert their custom and balances to their competitors.

The rise of the ethical customer is another consideration and a number of financial institutions have been accused of 'greenwashing' already. To the informed and committed ethical consumer, this is likely to be an unforgiveable breach of trust!

Regulation

In 2020, the FCA collected fines of more than £183m across 11 different firms/individuals. It is abundantly clear, the FCA will continue to take enforcement action against firms for non-compliance and, when you look across the 2020 fines, there are some clear signals for institutions as regards what they need to prioritise and focus on:

- Five of the 11 fines levied in 2020 (which translates to 98% of total fines levied in value terms) related to Principle 3 (Management and Control). Particularly, given the volume of ongoing regulatory change across all the regulators, firm's governance structures need to remain nimble and ensure risk is managed responsibly and effectively.
- Three of the 11 fines levied (which equated to 49% of total fines levied in value terms) had a Breach of Principle 6 (Customers' Interests). Institutions really do need to embed customers' best interests in everything they do and be able to prove they have done so.

To bring this to life, two of the top four fines in 2020 related to both Principle 3 & 6 for pre-pandemic transgressions:

- Lloyds Bank PLC, Bank of Scotland plc and the Mortgage Business Plc received a fine of £64,046,800 in relation to failings over mortgage arrears handling activities. The fine was deemed serious due to inadequate systems and controls, leading to challenges with setting up affordable payment plans which led to unfair treatment of customers and inadequate follow up training for staff in relation to appropriately identifying vulnerable customers. Furthermore, opportunities to correct failing procedures were missed, evidencing poor governance over remediation activity.
- Barclays received a fine of £26,056,400 for not treating fairly 1.5 million business and retail customers when they fell into arrears and/or experienced financial difficulties. This fine was deemed serious for not only the number of customers involved in totality but also that many of these customers were not identified as 'vulnerable' by the firm due to failure in the firm's systems and controls. Additionally, commitments made by the firm to correct their collections process were not implemented in a timely manner, again evidencing poor governance over remediation activity.

The regulatory challenges however are twofold:

1. Ensuring the right controls and monitoring are in place to meet existing regulatory standards. The FCA have a clear focus on ensuring vulnerable customers are treated fairly and have no appetite for firms failing to understand their customers' needs, nor for harm to consumers.
2. This focus on customer detriment is a large element of the Operational Resilience expectations of the three regulators which is one of several significant initiatives on the immediate horizon (e.g. AML, crypto assets, Brexit, etc.).

Whilst the regulators have taken a phased approach in implementing Operational Resilience requirements (in acknowledgment of the substantial work many firms will need to complete to meet the final hard deadline of 31 March 2025), the first requirements are due by 31 March 2022 and are far from insubstantial.

The 'Regulatory' Horseman will continue to cast a long shadow on the financial services sector and the 'to-do' list for most firms is considerable. Given the high expectations (and penalties for breaches), the large volume of work and the shortage of regulatory expertise, the earlier firms can implement regulatory horizon scanning, the more time they will have to plan, prioritise, design and implement new controls and monitoring procedures.

Competition

Challenger brands are embracing new technology and engagement models where customers are, in return, willing to transact and spend time understanding the differentiated proposition on offer. For example, Revolut have built and continue to develop a superapp that represents a 'one stop shop', offering every financial product a customer may need (FX, banking and investments in commodities, stocks and crypto). To complement their FX offering, and to drive engagement with their app, they have added a travel booking service to the app itself.

Similarly, in the wealth space, self-service offerings seem to be gathering pace as they offer a wider range of products and lower costs. This makes them more attractive to underserved segments as well as encouraging customer attrition from IFAs and fund managers that have offered poor value add or returns.

When many incumbent institutions talk about strategy, they are often responding to the already present phenomena in their environment as opposed to future proofing their business. For over a decade, banks have mused over a potential threat to their world from the tech giants such as Apple, Amazon, Facebook and Google. As time has passed, they have been less concerned, perhaps even complacent, as despite some initiatives like Amazon Pay and Apple Pay, they have not seen a radical erosion of their customer base or revenue by these or other challengers.

Competitors range across a broad spectrum, from the fintech upstarts to global heavyweights like JP Morgan who have created a UK focused digital bank, Marcus, and have expanded their proposition with their recent acquisition of the digital asset manager, Nutmeg.

Furthermore, Central Bank Digital Currencies (CBDC) are another unlikely instrument of competition. Ever since Facebook announced its intention to launch new services called 'Calibra' and 'Libra' (leveraging digital currencies and integrating these within Facebook, now called Diem), central banks have been looking to launch CBDC to protect their ability to use currency as a lever for fiscal control. However, if central banks choose to hold the CBDC accounts, this will divert customer funds to their own coffers. If banks no longer receive deposits how will they fund lending?

Obsoletion

For most organisations affected, their demise happens slowly; an established trend of losses eats into reserves and diminishes shareholder capital. It is only near the very end, when finance has been withdrawn or an incident makes a sudden and dramatic demand on weakened capital, for example by fraud, that they cannot continue. When a character in the Ernest Hemingway novel, The Sun Also Rises, is asked, "How did you go bankrupt?", he replies, "Two ways. Gradually, then suddenly!". This applies equally to obsoletion, especially in this extremely challenging political and economic environment.

When Lehman Brothers went bankrupt in 2008, many others, who came within a whisker of joining them, had to be rescued. However, the seeds of the banking crisis had been sown many years before and were varied. Exposure to sub-prime debt, overly ambitious acquisitions and setting too much store in the new credit default swap market were among the causes.

In hindsight, more attention should have been paid to potential risks and mitigation. Future proofing an organisation needs to take account of emerging technologies, competitor positioning (including that of new entrants), changing consumer attitudes and the macro political and economic environment. In tandem with this, it is important to have contingency plans in place.

The financial services sector's confluence of factors that threaten obsoletion through a chipping away of profitability or attrition of customers, includes gradual forces such as:

- The reduction in physical footprint and the erosion of footfall.
- The low interest rate environment (e.g. current accounts used to be a cheap source of funds for banks to lend out).
- Greater capital holdings required by the regulator, or indeed, ever-increasing regulatory demands in general.
- New digital banks simplifying and making the account opening process more customer friendly, especially in relation to completing ID checks and making payments. Often, they have targeted elements of the value chain, eroding traditional banks' revenue streams.
- New one-stop-supermarkets that mean you can access all your needs via one platform but avoid putting all your eggs in one provider's basket (e.g. Starling Bank's customer friendly Open Banking enabled API platform).
- A steady decline in car ownership reducing demand for retail finance.

These run alongside factors that have the propensity to make more of a sudden impact such as:

- Severe brand damage from prolonged technology outages, financial crime attacks and severe regulatory fines for breaches e.g. ineffective anti money laundering processes.
- An economic slump that leads to greater debt persistency in unsecured lending books and, ultimately, increases debt write downs that could obliterate profits or create losses that erode capital.
- The disintermediation of the financial services ecosystem, as has happened with mobile phone payments and PayPal, could lurch forward again. Indeed, if the big tech firms like Apple and Amazon leverage their platforms, their loyal clientele and offer compelling services and products, they would be significant competitors.

Never has it been more important for organisations to be open, to look around them and take an objective view, and determine what the factors are that are together influencing the organisation's present and the future.

Summary

The damage, as we saw in the financial crisis, is not just to single organisations but to the public confidence in the whole industry, with a consequential impact on the economy. As such, we can't afford to be blinkered or isolationist in how we understand the landscape in which organisations participate.

Our well-established banking brands have a strong history and heritage and for them to future proof effectively, a different and much more informed and interactive approach to horizon risk planning and strategy is needed. A holistic approach to sustainability and risk management is required to protect businesses and reputations.

Get in touch

If you would like to discuss any aspect of the topics which we have covered, then please get in touch with a member of our Financial Services team.

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