The circle of life

Mitigating risk in the financial services sector

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MOORE

Despite the fact that recessions are an accepted part of the great circle of life, and the general public's still-visible distrust of banking and financial services following the 2008 downturn; our banks continue to play a prominent role in the global economy. According to annual figures published by The Banker, British banks increased profits by a third last year, albeit still building back from historically low levels of profitability.

Identifying the risk areas

To ensure continued success of any institution, business or enterprise, it is vital to understand the risks it faces. It's all too easy to become complacent when riding the high wave of success.

Clearly the key to avoiding, or mitigating, any threat is to plan for it. Before that can be done, the threats need to be identified and fully understood in the context of each individual situation.

Now, we've been here before. Some of us have been here more than once. So, the lessons of the past are clear, particularly as they relate to financial institutions.

There are four clear risk areas:

1. Capitalisation

Insufficient reserves to deal with downturns or incidents within prescribed tolerances to avoid the taxpayer bailouts of the past.

2. 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.

3. Competition

Particularly from those embracing technology and new business models that appeal to consumers who are willing and eager to self-educate and self-serve online.

4. Obsoletion

The opposite of Futurism or investing in science & technology to safeguard your future, leading to long-term decline that cannot be reversed.

In this whitepaper we take an in-depth look at these four key risks to the financial services sector, and unpack what financial institutions can do to manage and mitigate risk for future success.

Capitalisation

Capitalisation - punishing capital

Why is capital critical?

Since the banking crisis of 2007 to 2009, the capital requirements of banks operating in the UK have been overhauled. The new rules seek to ensure that institutions could stand on their own two feet, even in the event of a recession or a material hit on reserves, such as losses, fines and litigation, rather than requiring government or taxpayer intervention.

The amount of capital a bank needs is calculated by adding together three pillars:

Pillar one - the basic minimum capital required based on credit, market and operational risk.

Pillar two - the regulator's assessment of bank specific risk. It's a qualitative measure that looks at the bank's size, maturity and operating history.

Pillar three - the amount required to support future growth.

Metro Bank's recent miscalculation of the capital it needed to support some of its commercial lending highlights the importance of the three pillars and the additional capital it now requires to continue its ambitious growth programme.

There are a number of options available when considering how to adjust the level of capital within an organisation, from issuing new equity to lowering the risk profile.

Option A: Issuing new equity

New capital can be raised by issuing new equity, such as through a rights issue to existing shareholders, an equity offering on the open market or placing a block of shares with an outside investor. This is often unattractive to existing shareholders given that a new share issue tends to reduce the market value of the existing shares. As such it tends to be a crisis measure if it is purely to boost capital for business as usual, as opposed to fund an investment such as an acquisition.

This route is not open to building societies, although Nationwide Building Society raised £500m in December 2013 through the issue of a class of shares called Core Capital Deferred Shares (CCDS). The CCDS class of share allowed Nationwide to retain mutual status and get around the limitations of member ownership where investors get only one share regardless of the amount they invest. It does however mean that, as the most junior-ranking investment, CCDS investors sit behind all other depositors or creditors.

Option B: Retaining profits

Whilst boosting profits would be the way favoured by most organisations it is not always easy and there is also the option of seeking to reduce the share of an organisation's profit it pays out in dividends. For most traditional banks the key component of their profitability is NIM (Net Interest Margin i.e. the spread between the interest rates it charges for loans and those it pays on its funding). This is why this comes under scrutiny as a key measure of banks' performance. Whilst marketplace dynamics and competition largely set the parameters for what banks pay for customers' savings and what they will pay as debit interest on their mortgage, credit card or overdraft facilities, organisations that are cost efficient have a natural advantage to offer more attractive rates or to take a greater spread to profitability than their competitors with a higher cost: income ratio. Coventry Building Society pride themselves on their low cost model and use that advantage to consistently pay amongst the highest savings rates in their sector to reward their members and honouring their mutual status.

Prior to the crash non-interest income formed a greater proportion of banks revenue and profits. This category included fees or commissions relating to pensions, investments, protection products and packaged current account fees. Given the raft of mis-selling cases and fines in the last decade the sources of non-interest income are much curtailed although many banks are cautiously looking at how they can compliantly increase the range of fee bearing products to meet customer needs. Both Santander UK and NatWest have launched robo-adviser investment offerings as a toe in the water to offer a wider range of products and reduce their current reliance on NIM.

Given the plethora of headlines on branch closures and headcount reductions clearly the focus on reducing operating costs and cost: income ratios is very much in vogue, not least to leverage the increased consumer demand for digital products and self-servicing their immediate requirements.

Option C: Shrink the balance sheet

Another choice open to institutions is to change the asset side of their balance sheet. This can be achieved by running down their loan portfolio or selling assets or books and use the proceeds to pay down debt. Recent examples would be Metro Bank's proposed sale of part of their loan book and Tesco Bank exiting mortgages and selling their existing book. These actions can be primarily driven by strategy as much as to free up capital. An asset sale can also boost capital by way of an accounting gain if the assets attract a higher price than purchase price/ book value.

Less abruptly, institutions can slow lending growth, thereby allowing retained earnings and hence capital to catch up. New assets carry an acquisition cost and can take time to reach break-even and create a profit.

Option D: Lower their risk profile

Risk adjusted capital can be bolstered by an institution reducing its risk-weighted assets by replacing riskier (higher-weighted) loans with safer ones, or with government securities. It is for this reason that many banks, and challenger banks in particular, given their more stringent capital requirements, favour loans to residential property instead of commercial property. It is also why lending rates are generally lower for residential property, recognising the greater demand by lenders for these assets and the lower risk weighting built into their pricing.

Key take-aways

If we learned anything from the financial crisis a decade ago it is that the banking sector does not work in isolation. The financial ecosystem is complex and is both affected by and affects the wider economy. The intimate relationship surrounding the role of banks within the ecosystem should not be dismissed. They need to navigate a finely charted middle course through stormy seas of inflation or deflation, employment, centrally set interest rates, housing market fluctuations, money supply, stock market prices, amongst many others.

The choices made as outlined above have a strong linkage to the macro economy. For instance, if banks seek to slow lending, or reduce lending to riskier projects, this could constrain investment by consumers and businesses with a knock-on impact on the economy. There is evidence post the banking crisis in 2007-2009 that tighter bank lending standards reduced bank loan supply, even whilst demand was high, resulting in a slowdown in lending growth.

It is unlikely that any one action to boost capital will be done in isolation and choices B to D will all require a holistic view taken, both of the desired impact on capital, and the consequential impact on the organisation and its ability to operate effectively. This holistic view should consider changes required to the future business model and the impact this has on distribution and operations. The Operating model should be revisited, and in particular where costs and controls sit. Given the importance of Senior Managers & Certification Regime (SMCR) this needs to be fully understood and mapped. Any changes must be undertaken in a reasoned and controlled fashion with consideration given to impact on the organisation's three lines of defence.

Regulation

Regulation - regulating the temperature

This section looks in more detail at regulation, how firms are responding to the changing face of our regulatory environment and how they embed compliance and risk management into their business change and transformation agenda. Just as the summer has presented wide extremes of weather from heatwaves to storms, regulated entities need to be prepared to regulate their temperature without creating unintended issues or unmitigated risk.

Our regulators and their objectives

The financial crisis demonstrated interdependencies in our ecosystem between financial services firms. However, it also highlighted the risk of certain functions within banks chasing growth and forgetting the consumer and, ultimately, market risk. In 2013 the UK's regulatory system was revamped to reduce this type of risk, leading to the formation of the Financial Conduct Authority (FCA) and Prudential Regulation Authority (PRA).

FCA objectives

Parliament has given the FCA a single strategic objective - **to ensure that relevant markets function well** - and three operational objectives:

Protect consumers - to secure appropriate protection for consumers.

Integrity - to protect and enhance the integrity of the UK financial system.

Promote competition - to promote effective competition in consumers' interests.

PRA objectives

For its part, the PRA's primary objective is to promote the safety and soundness of firms, mainly by seeking to avoid adverse effects on financial stability and, in particular, seeking to minimise any disruption to the continuity of financial services caused by the way firms run their business or upon their failure.

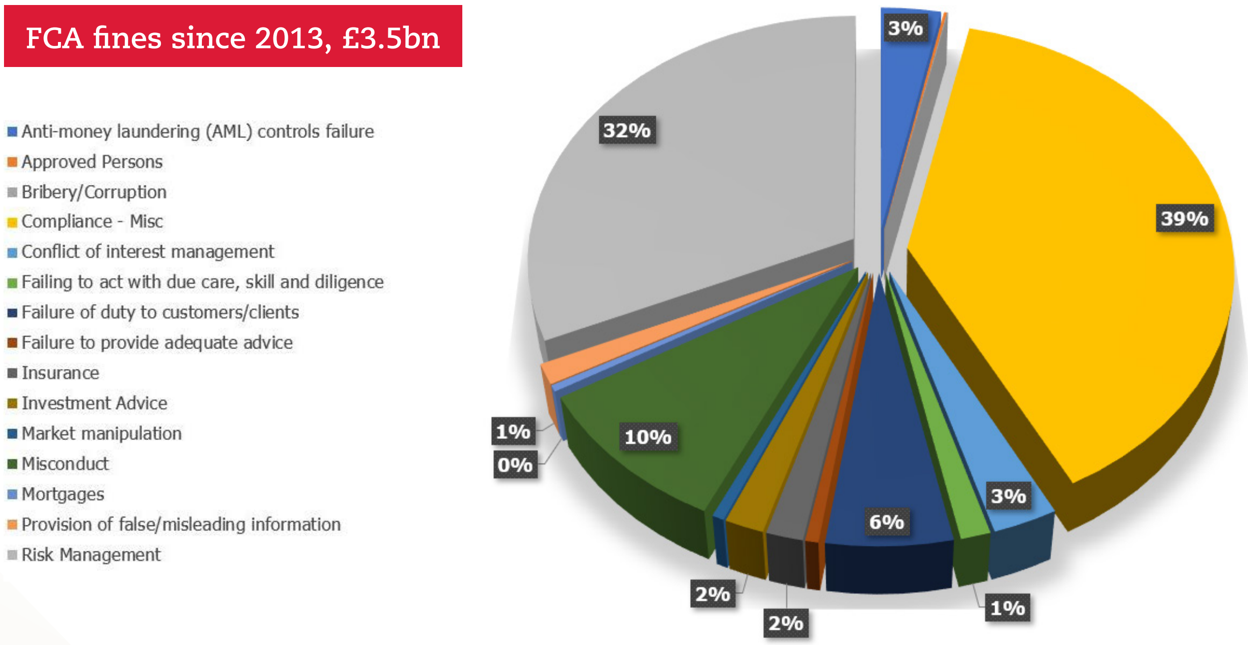
The PRA also has a secondary objective, that it must advance alongside its primary objectives, to facilitate effective competition.

The overall intent then is laudable and recognises lessons from our financial crisis a decade ago.

Looking back to look forward

The magnitude and scope of the fines issued by the regulators since their formation in 2013 are indicative of the emphasis they are placing on addressing the greatest shortcomings of financial institutions.

FCA fines since 2013, £3.5bn



It is notable that in recent years, the FCA has continued to impose significant fines for compliance failures.

In 2017, Deutsche Bank AG was fined £163m for failing to maintain an adequate Anti-Money Laundering (AML) control framework. This was the largest financial penalty for this type of failing ever imposed by the FCA.

In 2019 alone, Goldman Sachs International has been fined c.£34m for failing to provide accurate and timely reporting relating to 220m transaction reports, UBS AG has been fined c.£28m for failings relating to 136m transaction reports and Standard Chartered Bank was fined c.£100m for AML breaches in higher risk areas of its business.

Horizon planning

Shifting focus

We can expect more of the same from the PRA. Their focus on financial stability and preventing contagion risk involves the regulation of around 1,500 banks, building societies, credit unions, insurers and major investment firms. The bigger organisations that dominate the UK financial landscape are 'front and centre' of their attention given the concentration risk they represent. However, the rapid growth of challenger banks and their particular influence on savings and transaction services has meant they have become a systemic risk and consequently are subjected to a higher level of scrutiny than before by the PRA.

Despite this increased interest from the challenger banks, the PRA will be limited to the better known and riskier players in the market. The FCA however, since taking on responsibility for entities previously falling under the scrutiny of the Office of Fair Trading in 2014, regulates the conduct of more than 50,000 firms which includes the conduct of smaller firms. These smaller firms can expect more data to be gathered on them to support the FCA's oversight efforts.

Interpreting guidelines

When firms undertake their change scoping, prioritisation and budget setting exercises, they should pay close regard to the regulators' Business Plans and not just for their risk and compliance activity.

Increasingly the regulators expect compliance to be an inherent part of a firm's business model rather than a tick box exercise. With a "guideline" rather than "rules-based" system, the onus is on an organisation and its Senior Managers to understand their business model, determine the proportionality of regulation to their model and take considered and logical decisions that they can evidence. This has implications for the whole business and not just the risk function – particularly when the firm is undertaking large scale change initiatives.

Priority areas

Given that both the reach of the PRA & FCA is extending and our regulatory environment relies on guidelines (which are subject to interpretation), we believe the following priority areas should be reviewed by all regulated firms on a continual basis as part of their 'change track'.

Senior Managers and Certification Regime (SMCR)

At the end of 2019, the FCA and PRA extended the SMCR to all regulated firms in order to increase individual accountability of Senior Managers. Under the SMCR, firms need to:

- Map & track key roles and individual responsibilities for all affected functions;
- Demonstrate how Senior Managers can evidence "reasonable steps" to fulfil their responsibilities assigned under SMCR;
- Validate and measure the steps they are taking to improve governance, culture and controls;
- Update the mapping of key roles to take account of new initiatives and organisational change.

Vulnerable customers

The FCA has published guidance consultation on the fair treatment of vulnerable consumers setting out the FCA's view of what it requires of firms to ensure that vulnerable consumers are consistently treated fairly across the financial services sector. All firms involved in the supply of products or services to retail customers, even if they do not have a direct client relationship with the customers, will be required to:

- Ensure they have a suitable policy that sets out how they treat vulnerable customers;
- Apply this policy consistently via their systems, processes, pricing and people;
- Be able to evidence that doing the right thing for vulnerable consumers is deeply embedded in the firm's culture.

Demographic change

The FCA now carries out much more research and investigation than it has traditionally done and considers what the industry's approach should be to vulnerable customers. In June 2018, the FCA released the results of a survey titled "The financial lives of consumers across the UK" which looks at changing demographics across the UK, exposure to financial services and the needs and preferences of consumers identified as "vulnerable".

The regulator expects firms to have the ability to identify and proactively contact and support their vulnerable customers. They also require these firms to embed support mechanisms into their organisational change projects and to fulfil their responsibilities via their systems, policies, processes and people.

Fair treatment of existing customers

The FCA has already reviewed the life insurance and pensions sector in relation to the fair treatment of long-standing customers and it is now taking action on overdraft products. Additionally, it has put in place price caps on high cost short-term credit and it has signalled a review into pricing practices in the general insurance and savings markets.

Technology

There is an increasing understanding and involvement in sandboxing of "RegTech" i.e. the use of new technology to facilitate and monitor the delivery of regulatory requirements. RegTech automates or disintermediates elements of regulatory compliance processes, reducing the reliance on ever increasing risk teams and creating a greater dependency on data.

Brexit

The UK left the European Union (EU) on the 31 January 2020, entering a transition period that is expected to last until the end of the year. The current EU rules applied to financial services firms remain in place. However, institutions need to plan to account for the end of the transition period and the future relationship that will emerge. This is particularly important for firms with customer, intermediary and outsource relationships in the European Economic Area (EEA) as well as those with group entities based in the EEA and contracts referring to EU law. This will impact financial services firms' future operating models and capabilities in particular.

Summary

The thing that is most notable from the consultation papers is that the regulators are clearly signposting that their guidance should not be seen as a checklist of required actions. Instead, it provides options for ways in which firms can comply with their principles.

The deliberate ambiguity created by the FCA in particular, adopting a "guidelines" instead of a rules-based approach to regulatory compliance means that firms need to employ a holistic and comprehensive approach towards incorporating regulatory intent into their systems and processes. Furthermore, firms should be able to explain their rationale for the approach they have taken and be able to demonstrate that their compliance is embedded in their culture and that they are executing their responsibilities consistently and compliantly.

As the Nobel Prize winning economist Milton Friedman states, "One of the great mistakes is to judge policies and programmes by their intentions rather than their results."

Those immersed in change will be acutely aware that it is hard to translate intent into effective delivery. Ensuring that the regulatory "guidelines" are adhered to and embedded effectively into your change programmes is no small feat. It requires intimate knowledge of the regulations themselves and their intent, engagement right across the business and ownership from the top.

Competition

Competition - jockeying for position

A run for one's money

The phrase to 'jockey for position' is commonly used to refer to manoeuvring or competing to gain an advantageous position. The allusion is to horse racing and the jockeys' skilful manoeuvring and horse handling to gain a more favourable position may also transfer to the current 'form' in financial services.

Since the financial crisis a decade ago there was a consequential loss of trust in the incumbent players. Furthermore, there was general dissatisfaction with their levels of service and integrity, so much so, that both the PRA and the FCA made the promotion of effective competition part of their objectives. Add to that the fact that five banks controlled 85% of the UK current account market and the sector was ripe for disruption. The consequence of the sector's recent past is that there are currently many more horses and jockeys in the race.

This section looks in more detail at competition and how firms are responding to increased competition in the sector, both from their own kind (interspecific) and perhaps more challengingly from non-traditional businesses (intraspecific).

Looking through the lens

Interspecific and intraspecific competition are still two large categories and to better understand how the future may look it might be worth looking at competition through a number of different lenses.

Technology

I won't dwell on the march of digital and how this is reshaping consumer behaviour and interaction with the providers of the products and services they consume. Many other authors and their articles have delved into the what, the why and the how. It will suffice for me to say that digital is here to stay and it has changed the face of financial services in the last five years.

In the UK, where there is a thriving fintech scene, traditional models of finance management, banking, investment, currency transfer and more are being overturned by a wave of digital competitors. With a digital, and often mobile-first approach, this new brand of financial services firm is changing consumer expectations of banking and winning over customers with simpler finance proposition founded on being accessible, transparent, convenient, flexible and putting the customer first.

Needless to say, incumbents have been greatly unsettled by this change and many have adopted ideas and traits from digital challengers in order to remain competitive and as a means to reduce costs (migrating customers to self-service by the lowest cost delivery channel and reducing their face to face presence). There is no doubt that technology has increased competition, but it remains to be seen as to whether the incumbent's legacy systems and bureaucracy will delay their ability to respond or if their scale and deep pockets that enable them to buy in solutions will triumph at the end of the race for profitable customers.

Perhaps the biggest threat to the incumbent's oligopoly to date is from BigTech who can match scale and ability to invest. Amazon, Apple, Facebook and Alphabet (Google's parent company) are in the top 10 biggest companies in the world by market capitalisation. Most importantly, unlike the majority of fintechs, these companies can exploit their own Direct to Consumer (D2C) model as opposed to relying on a partner or affinity to access a customer base (B2B).

Rank	Company	Ticker(s)	Market Cap (March 18, 2019)
#1	Microsoft	MSFT	$902 billion
#2	Apple	AAPL	$887 billion
#3	Amazon	AMZN	$856 billion
#4	Alphabet	GOOG, GOOGL	$824 billion
#5	Alibaba	BABA	$471 billion
#6	Facebook	FB	$458 billion
#7	Intel	INTC	$243 billion
#8	Cisco	CSCO	$236 billion
#9	Oracle	ORCL	$192 billion
#10	Netflix	NFLX	$159 billion

Source: https://www.visualcapitalist.com/biggest-tech-companies-market-cap-23-years/

We have become used to the option of using PayPal (originally a subsidiary of eBay), and perhaps to a lesser extent Amazon Pay, when checking out after making a purchase online. In fact, PayPal offers a very customer friendly shortcut that on many sites avoids the need to sign in or register an account with the retailer. Such convenience could be surpassed with the launch by Apple of their 'Titanium' credit card in partnership with Goldman Sachs. The fact they have now 'joined up' and will together control elements of the payment ecosystem has the potential to shake up the traditional card payment monopoly. With the benefit of hindsight, will we see this as a seismic shift to the status quo?

One word of warning however is that it is difficult to expand without trust and the Cambridge Analytica affair still weighs heavily on Facebook's reputation with consumers and regulators. This may be sufficient to create additional scrutiny of and regulatory hurdles in their plans to create Calibra, their proposed digital wallet using a crypto currency calibrated to multiple currencies. Perhaps they are not irrevocably damaged but they may miss this particular wave of dramatic competitive change.

Customer segment or 'mindset' being targeted

Due to their history of being all things to all people, traditional players and certainly the largest organisations cover multiple customer segments. For example, RBS's ultimately unsuccessful deconstruction of Williams & Glyn was complex partly because it involved Corporate, Commercial, Small Business, two categories of Private Banking and Mass Market segments spread across just two million customers.

The essence of the big incumbent banks is that they do 4 things for their various customer segments:

- Transaction services – current accounts, debit & credit cards
- Savings - the range from instant access to term and cash ISAs
- Lending – mortgages, personal loans, overdrafts and more complex credit products
- Specialist services and advice (pension, investments, protection, wills, trusts and other private client offerings).

Being all things to all people requires a depth and breadth of expertise and gaining that expertise may present a barrier to competition on a like for like basis. Anyone trying to compete across all segments and for all products needs to have the capital, the systems, regulatory permissions, people with relevant expertise and sufficient scale. All of these essentials are hard (and expensive) to come by!

Product or Proposition?

Whilst the incumbents have sufficient scale and customer numbers to try to offer a full product set and to be all things to all people there are a number of mid-size and smaller players that almost certainly are not. This is clearly illustrated by Yorkshire Building Society withdrawing their current account in 2017 and reverting to a simpler and more traditional building society model of savings and mortgages.

Neo or challenger banks tend to be more focused and launch with a niche product or proposition eg specialist lender (Aldermore or Shawbrook), relationship manager proposition (Handelsbanken), transaction hub that also represents a data play (Monzo). Gathering significant quantities of transaction data enables insights into customer behaviour and preferences that should provide opportunities to personalise services and offerings to that customer or people with similar behaviours and preferences – an Amazon recommends with 'bells on'.

Other challengers seek to replace or remove part of value chain such as disintermediation of the existing ecosystem. For example, Square's business model is predicated upon providing payment processing, analytics, and, increasingly, lending capital to merchants.

Brand values

In addition to offering disruptive and competitive products and services, banks are also trying to distinguish themselves from the competition by implementing distinctive brand values.

For example, just last year, Monzo updated its core brand mission to "Monzo makes money work for everyone". The idea being that the average customers' interaction with money should be as simple and intuitive as possible.

Similarly, Handelsbanken, a relatively niche player in the market has distinguished itself by setting its stall out as a local relationship bank. They have dedicated account managers that understand the local market and community; they get to know their customers well and give expert advice. It is clearly doing something right and recent results from an independent survey carried out as part of a regulatory requirement for the Competition and Markets Authority (CMA) reveal that Handelsbanken has performed outstandingly across the various customer satisfaction metrics.

More traditional banks have been trying to match pace with the modern branding practices of new competitors like Monzo, Revolut, Atom and Starling. One strategy employed by larger banks has been to invest in multiple brands. As competitors brands strive to connect with customers in more specialized ways, they have been looking for ways to stand for something different from the master brand. For example, Halifax (part of the Lloyds Banking Group) is relaunching its brand with an updated logo and visual identity, as well as a new marketing campaign, as it looks to make the brand more contemporary, relevant and appealing to younger home buyers.

The significance of brand value can be gauged by the fact that CYBG, the owner of Clydesdale and Yorkshire Bank and Virgin Money will pay £15m per annum to use the Virgin name and will rebrand Clydesdale and Yorkshire Bank, as well as app-based bank B, as Virgin Money by the end of 2021.

Ownership

We should also look at ownership and business models to understand just how competition might reshape the financial services sector in the short to long-term. There are a number of different investors' expectations at play – from a short-term focus (eg hedge funds or private equity backed businesses) to long-term as displayed by member owned organisations (such as building societies and other mutuals).

Short-term focus

Hedge funds or private equity backed businesses usually expect the return on their investment will be from selling all or part of the investment at a pre-determined time in the future. Future growth and unique IP or data may be more important than current profitability to maximise the share price multiple on sale.

FTSE listed firms

Institutional investors such as pension funds own swathes of the equity in FTSE listed financial services firms. Whilst they will usually state that all equity investments are for the medium to long-term, within their own and managed funds, they will have a spectrum of customers with a mix of risk appetites:

- From those accepting higher risk in return for greater growth and/or income
- To those happy with lower, but less volatile, returns for those with a lower risk appetite.

Private listed organisations

Much depends on the group of investors' objectives and they can be more aggressive and look for growth to generate a larger goodwill element in a future sale or in the case of some (eg multi generation family owned businesses, such as Weatherbys Private Bank and C. Hoare & Co), they can from time to time choose to accept lower returns in return for retaining control of a majority shareholding.

Long-term focus

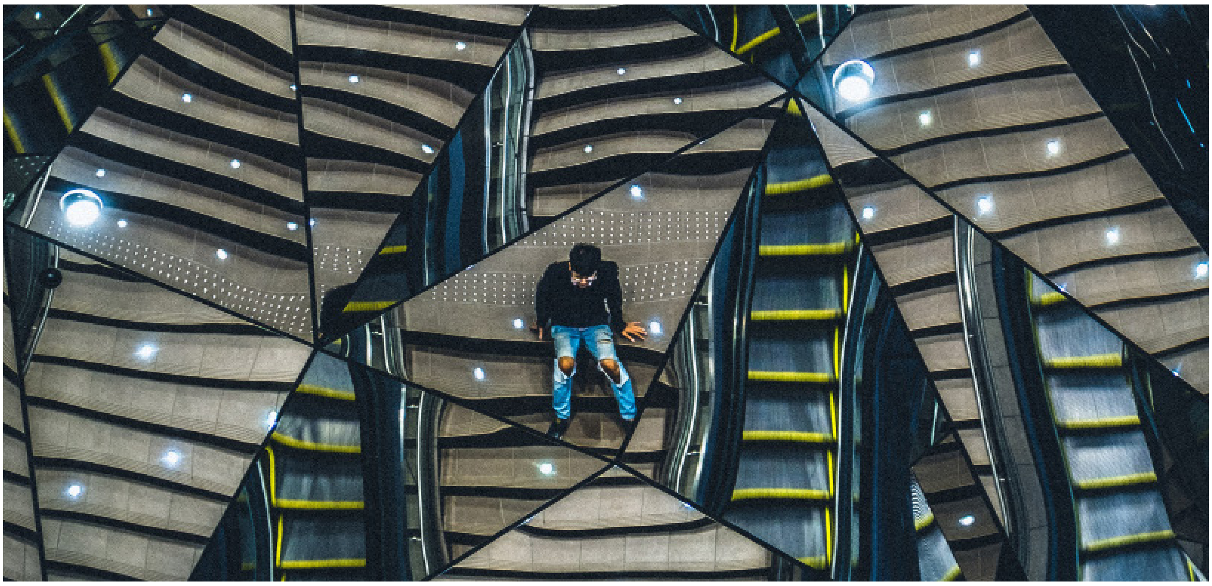
Mutuals are an example of this and are able to offer benefits to their members yet fall short of the returns that commercial investors are inclined to expect.

Breaking the myths

1. Nirvana has until recently been increasing share of wallet and the number of products a customer holds with your organisation - Open Banking and API platforms break this stranglehold as consumers can easily access products from multiple financial services providers and don't need to put all their 'eggs in one basket'.

2. Only banks can make payments - this myth has been compellingly broken by PayPal and Apple with their 'Pay' offerings and it looks as if the payments space will suffer further disruption as technology evolves and bypasses point of sale terminals in particular. For example, Bancontact has introduced a mobile application in Belgium to streamline its payment experience. Using their mobile app, customers can identify by scanning a QR code presented at the time of payment. Each transaction is then confirmed with a PIN.

3. Current accounts control the relationship - not any more as although a banking app may be front page on your smartphone screen this competes with other popular apps for 'front of mind'. This means that the card linked to your electronic wallet, (often a secondary bank), Spotify or Amazon may take a larger role in a consumer's day to day life than the account to which their salary is paid in to!



4. New customers get the best deal as loyalty is a given - there is a growing sense that this is becoming a point of principle for many customers and may be the thing that breaks what is often called the lethargy that has led to the largest players retaining their dominant market shares. Banks rolling over term deposits on tiny deposit interest rates and insurers offering poorer policy premiums to existing customers than to acquire new customers beware.

5. The branch is dead - while it is true that mobile banking has replaced some of the functionality previously offered by the bank branch, the branch still has a role to play as an advisory centre, community space, brand advertisement and financial education resource.

6. Digital and social media are replacing traditional marketing channels - while more consumers are doing their shopping using digital and mobile channels and social media marketing can be effective, these channels serve to compliment and supplement traditional channels as opposed to replacing them. Indeed, in recent months both Monzo and Hey Habito have leveraged traditional marketing channels to accelerate customer growth.

Give & take

Competition may just be the initial phase like jockeys, who in the early stages of a race, test themselves and their peers to establish the pattern that will play out to the end. In fact, we are already seeing competitors becoming suppliers to incumbents with alliances and partnerships being formed. Time will tell whether they are yet in their final form however and many may yet lead to true partnerships or joint ventures.

For example, a strategic joint venture by Virgin Money and Aberdeen Standard Investments is transforming Virgin Money's retail investment proposition to drive significant growth in funds under management and capital-efficient returns.

Other players will also look to consolidation and look to gain scale and to bridge capability gaps via merger or acquisition activity. CYBG's successful £1.7bn deal for Virgin Money is indicative of this strategy. In recognising the complimentary elements of their respective offerings, the marrying of the two propositions creates potential for greater scale (potentially the 6th largest UK bank) and market presence, providing, of course, that integration is not too much of a distraction and can be undertaken effectively.

The success of collaboration and consolidation, however, hinges on the 'strategic and cultural fit' and the ability of the buying firm to seamlessly integrate a new partner or acquired firm. Failure to do so may result in a series of issues which negatively impact the potential opportunity.

HG Wells wise words seem to fit whichever side of the track you are on, incumbent behemoth or upstart challenger:

"Adapt or perish, now as ever, is Nature's inexorable imperative"

Obsoletion

Obsoletion - gradually, then suddenly

Arguably, the last decade has seen the financial services sector facing the most fundamental attack that it has faced in over a century, due to technological changes leading to new competition and driving swings in consumer behaviour. Add to that an extremely challenging political and economic environment and the Ernest Hemingway quote from his novel 'The Sun Also Rises' springs to mind. When a character in the book is asked "How did you go bankrupt?" he replies "Two ways. Gradually, then suddenly!"

This section looks in more detail at obsoletion. We begin by examining the key threats to financial services firms and finish by providing a strategic framework which can be used to avoid long-term decline.

Cataclysmic change

The status quo has fundamentally changed in financial services and in a number of other sectors including music, film, media, automotive and retail (Thomas Cook, House of Fraser, LateRooms are just a few of the many casualties). Digital technology and smartphone usage has fundamentally altered how people interact with, and what they expect from, their service provider.

Increasingly, digital technology is not a differentiator, but it is instead a hygiene factor for most consumers who want to be able to do simple things like pay bills, check their balance and track spending from their phone without experiencing any wait time or delay.

Updating, refreshing and upgrading technology has become a required core competence for many organisations looking to keep up with the unceasing march of technological progress. However, many of these firms do not have the right people, the right environment or the reserves to be able to keep up.

A recipe for disaster

Whilst digital technology is fundamentally altering how financial services firms engage with their customers, it is not the only potential driver of obsoletion.

There is a theory that the confluence of a number of factors led to the extinction of dinosaurs. Their departure was hastened by a combination of factors such as climate change, increased competition for food, prey evolving to better hide themselves from the ancient predator and the movement of tectonic plates changing the landscape. Yet, the birds we see in our skies are believed to be evolutionary ancestors of dinosaurs – they survived in a different form!

This might just be a useful metaphor for the drivers of obsoletion and the means of averting long-term decline – you have to evolve in order to survive.

“Gradually, then suddenly” for financial services firms

We have laid out below the confluence of factors that we believe threaten obsoletion both gradually, through a chipping away of profitability or attrition of customers and suddenly, through shock market changes.

Gradual forces

- The low interest rate environment;
- Greater capital reserves required by the regulator;
- New digital banks simplifying and making the account opening process customer friendly, especially in relation to completing ID checks and leveraging BACS functionality to remove delays in getting access to account credits (earlier access to their salary may encourage many customers to make their digital bank their primary account);
- 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 (eg Starling Bank’s customer friendly API platform);
- A steady decline in car ownership reducing demand for retail finance.

Sudden forces

- An economic slump that leads to greater debt persistency in unsecured lending books and, ultimately, increases bad debt impairment that could obliterate profits;
- The disintermediation of the financial services ecosystem as has happened with mobile phone payments and PayPal could lurch forward again. Indeed, the launch of Apple’s titanium credit card that leverages their Apple Pay platform, their loyal Apple clientele and offers best in market conditions could prove extremely attractive to the market.

Survive and thrive - lessons from the past

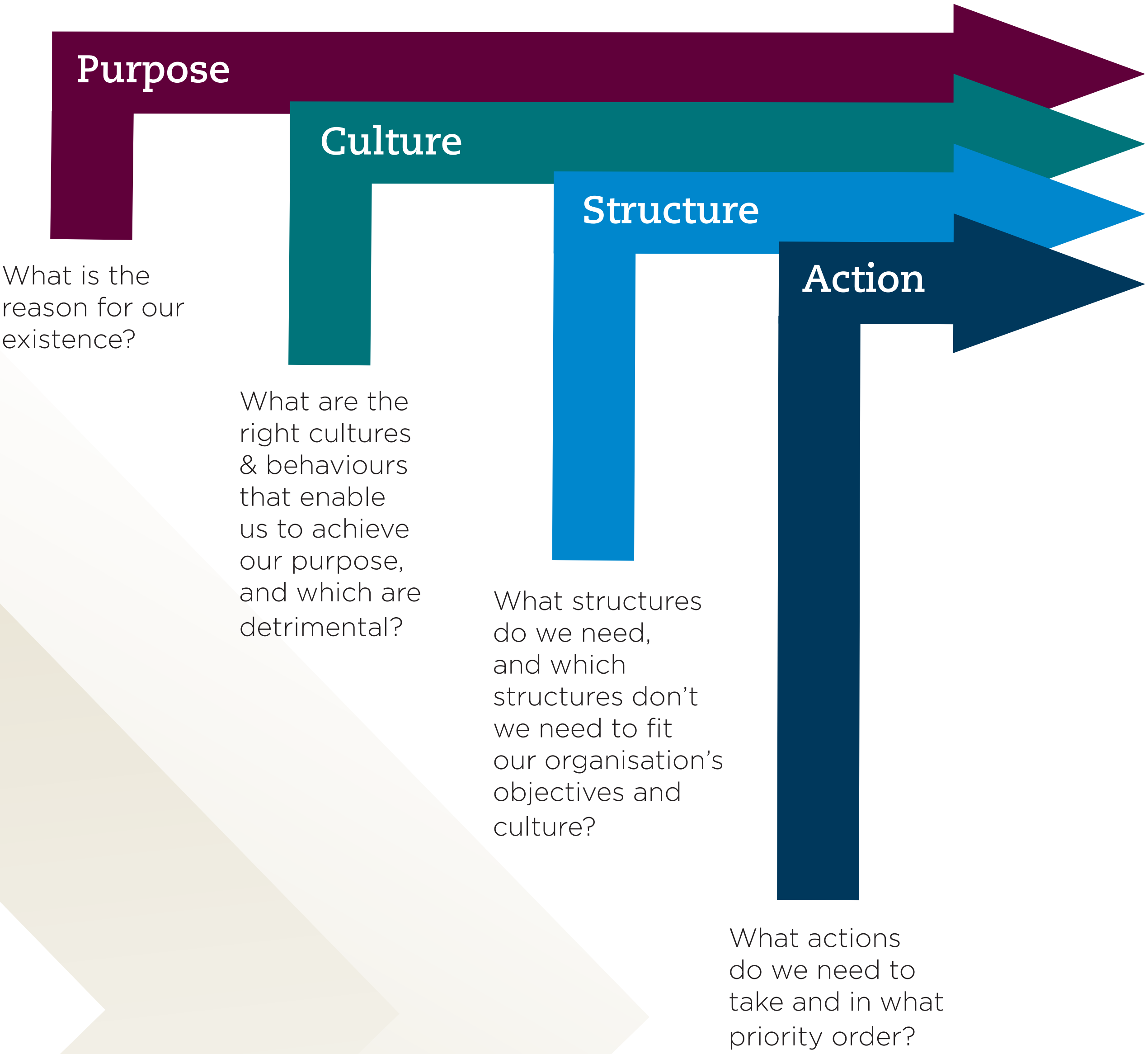
One company that recognised disruptive change and responded effectively was IBM. In their case, they saw that the information technology industry was rapidly becoming commoditised and shifted their portfolio to a more balanced mix of high-value offerings. This meant growing their service and software businesses, both through significant internal investments and through acquisitions. Indeed, they acquired more than 200 companies at a cost of $30bn to help fill out their portfolio of products and services in strategic growth areas, such as analytics.

They also changed their operating model from a federated model (by country or region) to a shared services model. Nine out of ten IBM employees now focus on developing, producing and delivering high-value solutions for clients rather than servicing the internal workings of IBM.

The swift and dramatic action taken by IBM’s CEO transformed the organisation from the worst loss maker in a single year in US history ($5bn loss in 1992) to a firm which boasted a non-GAAP (non-Generally Accepted Accounting Principles) profit of $12.7bn in 2018.

Avoiding obsoletion - Johnston Carmichael's obsoletion survival question set

In order to protect future profitability and revenue streams, firms need to adapt to survive. At Johnston Carmichael, we have developed a series of sequential questions that we believe firms should ask themselves in order to avoid the threat of obsoletion. These questions cover four key areas of a firm's operation:



Purpose: What is the reason for our organisation's existence?

In the IBM example, their revised identity was very much around developing, producing and delivering high-value solutions for clients in order to turn around financial performance. For your firm it might be:

- For investor return (dependent on the type of organisation and investor – private equity owned businesses typically look to maximise return and have a 3-7 year outlook whilst institutional investors investing pension funds will look for stable lower returns over a much longer term);
- To protect and reward members;
- To serve the communities in which they operate (eg credit unions);
- To serve a greater purpose (eg environmental or green finance).

Guiding Principles

But the purpose alone is too broad a concept – it is often not tangible enough for those looking to initiate organisational change or the employees looking for inspiration and direction. Firms must, therefore, also articulate the Guiding Principles that they will operate under in order to achieve their defined purpose. For a building society whose purpose is to reward members, this could include providing products which consistently maintain member return at a particular level.

When setting Guiding Principles, firms must first take account of their own individual circumstances and their competitive environment – they should consider:

- What is happening in the market?
- What are competitors doing?
- What are the target customers' requirements and what are they increasingly open to?
- What is the macro environment like and what are the emerging trends?
- What regulation are you facing now and in the future?

Example

Deteriorating results gave IBM their wake up call and finally answering these questions gave them the route to turning around their business. Likewise, your ability to be objective and to simultaneously have the appropriate experience and the expertise to analyse, digest and decide a relevant and proportionate path ahead are becoming more important to your business. Yet, be under no illusion, the requisite experience and skills are scarce resources!

Culture: What is the right culture that enables us to achieve our purpose?

Culture is often cited as the primary reason that strategic initiatives fail, but if you get it right it can also set the conditions for success.

It has become fashionable to focus a lot of attention on capturing the hearts and minds of Gen Z and of Millennials and shifting the change methodology from waterfall to agile. Words such as 'agile', 'non-bureaucratic', 'empowered' and 'employee recognition' are used to describe the target culture. Often at this stage, organisations move on too swiftly and the desired culture is never embedded – it is left as a series of visionary soundbites rather than tangible behaviours.

Words are cheap

Everyone has heard the phrase 'words are cheap'. In the case of effective cultural development, your employees and customers need to be aware of, understand and resonate with your chosen culture. Most importantly, they need the words and promises to be acted out, consistently and repeatedly.

My experience is that choosing a few symbolic things to be highly visible will demonstrate the authenticity of the new culture. I refer to this as the cultural totem pole, where each of the faces on the pole should represent a significant element of the cultural change that you wish to embed. Every time your employee or customer makes eye contact with one of the faces then your new culture will be reinforced.

Example

General Electric implemented a successful culture shift by abandoning its formal annual reviews in favour of immediate performance feedback. Regular in-person and online feedback – an important method of offering individualised, manager-to-employee mentorship, is proven to foster a more dynamic culture and increased employee retention by timeously reinforcing positives and constructively dealing with 'development' areas.

Structure: What structures do we need, and which structures don't we need to fit our organisation's objectives and culture?

Structures can include organisation design, systems, processes, policies and governance. What we are looking for are the right structures that both reinforce and support the desired results, culture and experience.

Example

By the early 2000s, Google was a phenomenal success. However, in the following decade, it's meteoric success and expansion resulted in an increasingly complex entity to manage with intertwining goals, teams, funds, and managers. In 2015, Google's co-founder, Larry Page, broke up Google into its constituent parts, making each its own company all under the ownership of a new umbrella corporation called Alphabet. Each of Alphabet's companies has its own goals and a CEO focused solely on those goals. The structural reorganisation has proven to be a success with each company responsible for its own expenditures and income, meaning that they also enjoy a new sense of accountability and ownership.

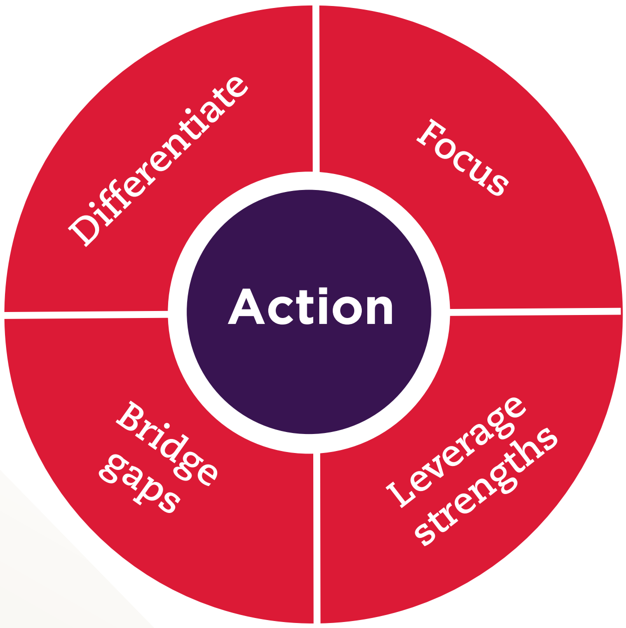
As well as looking for the positive traits of the new structures it is always worth considering the unintended negative consequences. For example, in looking to increase responsibility and ownership an unintended consequence might be internal competition for budget and resources and an increase in internal politics.

Action: What actions do we need to take and in what priority order?

Your purpose, culture and structures are your design blueprints for your future organisation – they are your aspirational future state to combat the threat of obsoletion. However, they need to be turned into action – otherwise they are likely to become dusty blueprints on an obsolete shelf. There are four broad categories of action:

Differentiate – determine which game changing initiatives will deliver your strategy. Measure the change to ensure you are delivering differentiated results and displaying the desired behaviours.

Focus – before you can effectively begin your strategic change, you need to pick your priorities and at the same time stop doing certain things – you don't have unlimited resources after all. The Focus stage concentrates on determining your priorities and removing unnecessary projects and operations which do not align to your purpose, culture and structure.



Bridge gaps – decide which gaps you need to bridge within your existing capability set in order to deliver your future strategy. Seek investment where required.

Leverage strengths – determine your core competencies to leverage as strengths and prioritise how you use these to drive forward your strategy and deliver quantifiable and qualitative results.

Lastly, but by no means least, communicate, communicate, communicate! Regularly communicate progress along the journey, celebrate successes and advise of remedial action when required.

Communication (preferably two way) demonstrates commitment to the journey as well as to the changes sought. For example, Monzo have placed communication at the heart of their purpose of solving customers' problems and their tone is very much about working together. They have also sought to articulate that tone on their website and explain how they will communicate in writing.

Become a bird, not a dinosaur

Never has it been more important for organisations to review the confluence of factors which may lead to their obsoletion and to take action to avoid long-term decline. If you do nothing else after reading this article, do three things:

1. Stop looking over your shoulder at your traditional competitors and look instead at what your customers see.
2. Don't be tempted by a copycat strategy, even if elements seem attractive. It is highly likely that there are fundamental differences between your role model and your own organisation and consequently the danger that you are not comparing like for like. Blindly following a competitor with a flashy strategy could also lead to obsoletion – your capital is, after all, finite!
3. By all means seek external experience, expertise and objectivity to help you develop a tailored strategy, and execute it brilliantly!

Circle of Life summary

The damage as we saw in the financial crisis is not just to single organisations, but to the public confidence and 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 and the risks that they face.

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

Get in touch

If you would like to discuss any aspect of developing your strategy or the translation of your strategy into an effective and results orientated organisational change programme, then please get in touch.

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