THE RISE OF BUSINESS RISK IN BANKING

BANKS NEED TO BE MORE MINDFUL THAT DEMAND FOR THEIR SERVICES COULD COLLAPSE

Barrie Wilkinson

Bank failures have historically been caused by risks that are specific to the industry – or, at least, that are of much greater consequence in banking. The savings-and-loan crisis of the 1980s in the United States was a case of risk arising from the maturity-mismatching characteristic of banks' balance sheets. The collapse of Barings Bank in 1995, caused by Nick Leeson's "rogue trading," was a case of event risk, to which banks are also highly exposed. And the financial crisis of 2008 was a case of credit risk, of which banks carry more than any other kind of business.

The major risk that most businesses face – that demand for their services will collapse, perhaps because increased costs drive up their prices or because more efficient competitors steal their customers – has been of little concern to banks.

And rightly so. Banks have enjoyed advantages which minimize their business risk (as it is commonly called). The large fixed costs associated with banking have acted as a barrier to entry for potential competitors, as has the time and expense of creating a trusted brand. The cost of shopping around and switching has made bank customers sticky. And the vast quantity of customer data that banks naturally collect gives them an advantage in understanding the risks presented by customers, in designing products for them, and in marketing to them.

But new developments in technology and regulation are eroding these advantages and thereby increasing the business risk faced by banks. Failures arising from business risk unfold more slowly than those arising from the characteristic banking risks. But the risk is no less serious for that. The next bank failure in the US or Europe is as likely to come from a loss of customer business as from an explosion of bad debt or other financial shock.

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THE THREAT OF EFFICIENCY

Building and running banking systems is expensive. This mainly fixed cost has been a barrier to entry and, hence, an advantage for established banks. Now, however, banks are disadvantaged by their systems. Decades of upgrades, bolt-ons, and integration have made the systems unwieldy and expensive to maintain and modify. New entrants with clean digital technology have a distinct cost advantage (in the areas where they now compete).

Banks have been trying to digitize their current infrastructure, but the job is proving complex and slow. "Re-platforming" a large bank is a three-to-five-year effort, which typically delivers a lot of pain and expense but little improvement in operating cost or performance.

Some have decided instead to "greenfield": Rather than upgrade what they have, they start again from scratch. While keeping the old infrastructure running, they form a new digital bank with a management team that has the autonomy required to build something from scratch. Once the new bank is built, customer accounts are migrated to it and the old infrastructure is discarded.

These new banks are being built in the public cloud, using the same modern technology stack pioneered by the tech giants – scalable,

lean, and modular. A new launch costs around $60 million, takes between nine and 18 months to complete, and delivers a cost-income ratio between 15 percent and 30 percent once the new bank is in run mode.

This poses a grave threat to banks that, for whatever reason, choose to stick with incrementalism and the cost-income ratios between 60 percent and 70 percent that it entails. They will be unable to compete on price with banks operating at half the cost, or to invest as much in providing better customer service.

Indeed, even greenfielding may underplay the potential for radical efficiency gains in banking. Banks need not build their own systems at all, relying instead on a third-party supplier of the machinery of banking – the IT platform, analytics, and other operational processes. The advanced technology and scale of these third-party suppliers could drive costs even lower, to the region of 10 percent to 20 percent of current cost-income ratios.

More importantly, these third-party "full stack" suppliers would eliminate a major barrier to entry. Any company that can build a brand and proposition adequate to attract customers and obtain a license can compete without any investment in the hardware or specialist skills required to run the machinery of banking. Even if incumbent banks achieve these cost savings, one of their competitive advantages will be gone.

THE THREAT OF OPEN BANKING

As the collapsing cost of the machinery of banking undermines one advantage of incumbent banks, regulation is undermining another. The regulatory drive towards "open banking," embodied in the EU's revised Payment Services Directive (PSD2) and the General Data Protection Regulation (GDPR), will loosen banks' grip on their customer data. These regulations will force banks to share their previously proprietary data, not only with their customers, but also with competitor banks and third parties who have been given permission by the customer.

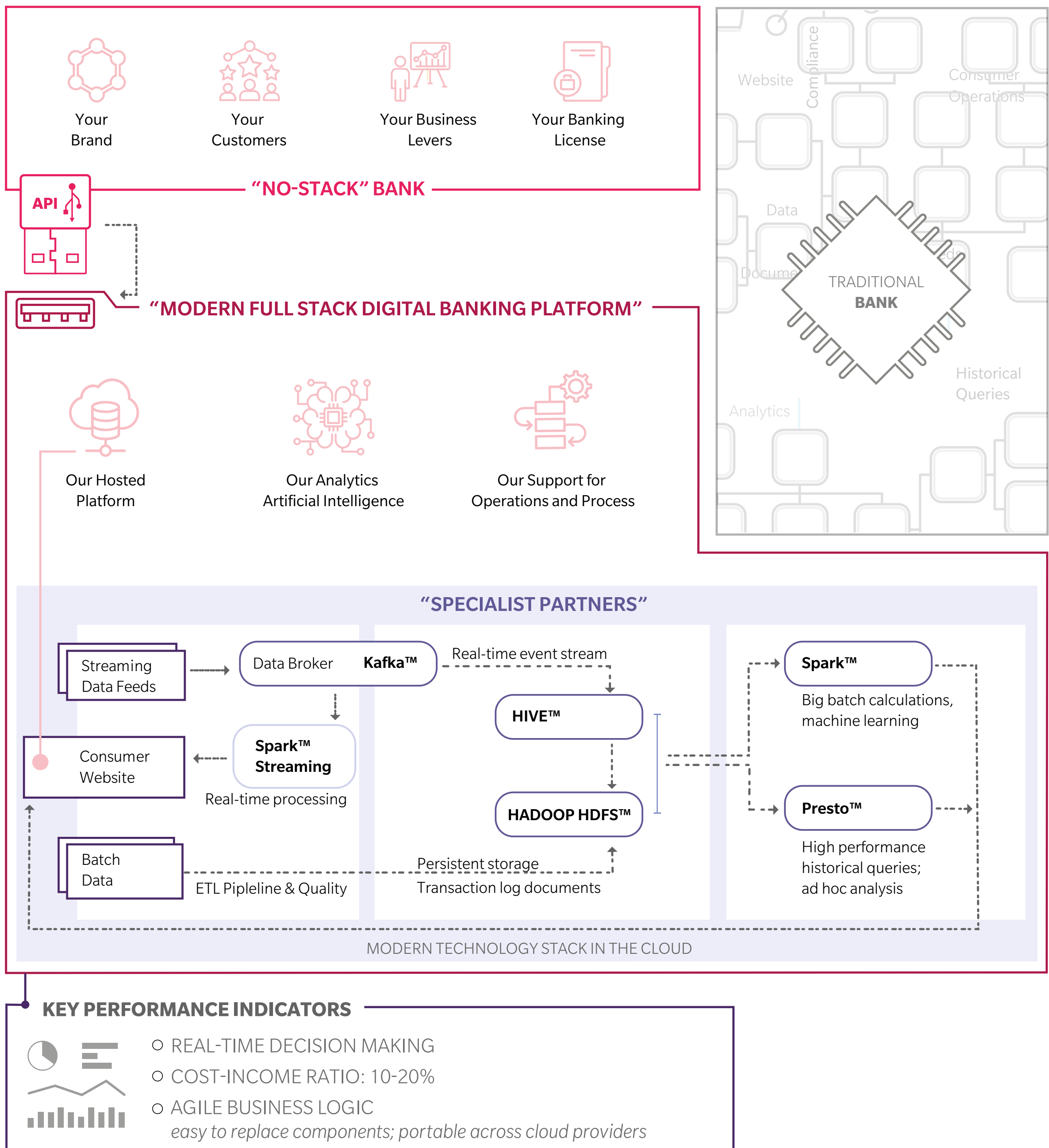
By making banks' (formerly) proprietary data effectively open source, these regulations will greatly reduce their advantages in risk assessment, proposition design, and marketing. Competitors will be in a better position to understand a bank's customers and to target the valuable ones. Combined with the reduced cost of shopping around created by online banking, open banking is likely to reduce customer stickiness. Customers won't merely wander off; they will be pulled away. Though it will not be recognized on their balance sheets, open-banking regulations devalue one of banks' most valuable assets.

BUSINESS RISK IS FOR BUSINESS LEADERS

Incumbent banks still have advantages. Depositors seem to prefer established banking brands. Compliance is becoming a larger and largely fixed cost, in which the incumbents have much more experience and expertise than potential competitors. And, perhaps most importantly, banks have vast balance sheets (capital) with which to perform the basic banking functions of risk intermediation and maturity transformation.

Yet there can be no doubt that the weight of risk facing banks in advanced economies is shifting from the traditional banking risks towards business risk. This means that the weight of risk management must shift from the chief risk officer and the risk function, to the chief executive officer and the C-suite. These threats cannot be handled by better risk modelling, risk limits, monitoring, and the other tools of standard risk management. They go to the heart of the banking business model and will require profound strategic responses.

EXHIBIT 1: NO-STACK BANKING



Source: Oliver Wyman analysis

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