

THE GOOD BANK

A CONCEPT FOR IMPROVING
THE GLOBAL FINANCIAL INDUSTRY

Full programme report

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preface

The Good Bank is an Economist Intelligence Unit research programme sponsored by Credit Suisse, Mazars and SAP and supported by Capgemini. This programme brought together dozens of experts to discuss the best ways to improve banking and what that would mean to a wider variety of stakeholders. It was fuelled by an online debate and culminated in a live webcast that is available globally. This was informed by contributions from the online forum, desk research and further in-depth interviews with banking executives and industry experts. This report was written by Dan Armstrong and edited by Brian Gardner. Our sincere thanks are due to all who contributed their time and insights to this project.

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executive summary

Five years ago, Lehman Brothers entered history as the largest bankruptcy ever. The financial crisis that followed triggered the most severe economic downturn in decades. A widespread sense of injustice flourished in response to government bailouts of the banking industry. The loss of confidence in the financial sector extends beyond fringe groups or left-wing academics to include many who had previously been the industry's staunchest defenders. This has led both to more stringent regulation and to the recognition that the banking system requires wholesale re-examination.

Accordingly The Economist Group brought together experts in financial services through an online platform and a live discussion in London to address this critical question: What does it take to be a Good Bank? Is it possible to earn back the public's trust? How can banks provide the credit that economies need to grow while satisfying shareholders, regulators and protecting depositors? What is needed to embrace prudence, efficiency and ride the wave of technological innovations spreading through the rest of the economy?

Asking banks to change is a daunting task, but in the last five years much has been done to shift from crisis towards a more stable future. This work is hardly completed but the forum convened via The Economist Group was not intended to provide a blueprint. Instead, it was meant to provoke debate and discover common ground. The pillars that we investigated at the heart of a good bank are trustworthiness, efficiency and innovation. We employed panel discussions and over a dozen additional interviews with banking experts, regulators, financial services executives, innovators and advisors.

This revealed that while discord certainly exists, there is also a surprising amount of consensus. One significant area of disagreement is how banks can best serve the "real" or non-financial economy. Is it by sticking to traditional activities such as deposits, payments and lending? Or do liquid markets and price discovery require large trading books in foreign exchange and derivatives? A useful distinction

exists between global banks that make markets, and national or local banks that primarily take deposits and make loans. The former require more thorough and coordinated oversight, given their central role in the global financial system.

Agreement exists on the need for banks to maintain profitability while downplaying the metric of return on equity, too often fuelled through leverage. In fact, there is a consensus that the days of 25% returns on equity are over. According to the consulting firm, McKinsey, the global average return on equity is at one-half of its pre-crisis peak— a healthy development, argued several of the contributing experts. There is general agreement that banks need to focus on clarity and operational excellence in order to reduce costs and become more agile in providing new services. Furthermore, certain investments in social, mobile and analytics hold the promise of new business models and personalised customer offerings. Those banks that do not embrace new innovations may lose out to new market entrants willing to do so.

It is clear that chief risk officers have more authority, better models and are focusing on risks that had previously received little attention. Capital buffers are more robust and boards have worked to strengthen their oversight. Yet this scenario has happened before and it is not clear that banks can fully escape a bubble-to-crash credit cycle that both mirrors and intensifies business cycles.

It is telling that not a single interviewee was willing to defend the status quo. The extent of transformation demanded varies significantly but all participants recognise the need for change. This highlights the most problematic quality required of a good bank: the trust of a still sceptical public. To trust any brand, it must be authentic, clear, and represent values that its customers share. While rancour over bailouts lingers, banks need to do more than apologise for past mistakes and reform their governance. They need to act in the best interests of their customer and be seen to do so. Old sins are not forgotten, but they can be forgiven if banks help drive to a return to growth and prosperity while prudently managing their risks.

the good bank introduction

Unlike the smartphones we carry in our pockets, banks don't become visibly better every year. In an era of industry disruption, banking can seem impervious to change—at least, of the positive sort. In fact, some would argue that banks are becoming worse or their flaws have become more apparent:

- Shareholders have watched shares sink below book value;
- Taxpayers are still upset that governments have absorbed losses after bank managers pocketed leveraged gains;
- After the post-crisis credit scarcity, when lending to small and medium-sized enterprises (SMEs) in the UK dropped by an average of 3.8% per year for four years¹, SME borrowers have a new appreciation for the ephemeral nature of credit;
- The entrepreneurs peeling off customers with new offerings believe that traditional banks haven't served customers well.

The sense that banks have not lived up to their potential runs broadly and deeply through society. There is broad agreement, at least among policymakers and the public, on what banks should not be. It is less clear what they should be. To say that we need "good" banks begs the question. Good for whom? To shareholders it means a rising stock price. To bondholders, the ability to repay. To employees, it's compensation and benefits. To regulators, following the rules and prudently managing risks. To depositors, the safekeeping of their funds, and to society, honest support for economic growth.

A good bank is built on three pillars: effectiveness, trustworthiness, and innovation.

- An effective bank delivers value to its shareholders by bringing value to its customers. It is run efficiently, holds down costs, takes the informed risks needed to steadily increase earnings over

time, and operates within the letter and spirit of law. The effective bank balances such competing priorities to prosper as a business today while building a franchise for the future.

- But the most important quality of the good bank is not effectiveness. It is trust. In the public mind, the overextension of banks and their subsequent collapse is inextricably linked with the slowdown in European economies and attendant social and economic tensions. Without the confidence of regulators, shareholders, borrowers, depositors, and the general public, banks cannot stand between counterparties. Given the harm wrought by the crisis, the onus is on banks to win back public trust—and regain their position as trusted financial advisors.
- Innovation isn't a necessity for banks, but then neither is survival. Good banks can get by in the short term without adopting innovations, but those that do not adapt will fail to attract new customers and may eventually wither away. Most banks today have mobile applications, the ability to accept scanned checks and multi-step verifications of remote logins—all capabilities that did not exist a short time ago. If bankers are not quick, they will see non-bank competitors peel away underserved groups of customers with more convenient and less costly services.

In theory, the three qualities reinforce each other. An effective bank inspires trust and generates the cash necessary to innovate. A trustworthy bank reassures customers and regulators, which is especially important when a leap of faith is required—in difficult times, for instance, or when the bank is asking stakeholders to try something new. And innovations, especially when they are transparent and consistent with the interests of customers, can reduce costs and mitigate risks

¹"Trends in Lending", Bank of England, April 2013, p4, Table 1A,

Lending to UK businesses. Note: SME lending declined in other countries as well.

²See "The Good Bank" site at: <http://event.wavecastpro.com/thegoodbanklive/>

effective, trustworthy and innovative **reinforce** each other

	Effectiveness because:	Trustworthiness because:	Innovation because:
The effective bank reinforces:		Customers are more likely to trust an entity that is well-run and will be around for the long term.	Effective banks are more likely to have the resources to invest in innovation.
The trustworthy bank reinforces:	Customers want to do business with a bank that follows the rules, behaves in trustworthy ways and does socially useful things.		Innovation often requires that customers change their behaviour or do something new. They're more likely to do so with a bank that they believe has their interests at heart.
The innovative bank reinforces:	Innovation can be harnessed to make banks more effective, provide a competitive edge and reduce the level of risk.	Innovation promotes trust when it is transparent and the goals it promotes are consistent with those of the customer.	

But there are also conflicts and trade-offs among the three qualities. In fact, there are conflicts and trade-offs within each of these qualities. Bond and equity investors have different interests, yet the effective bank must satisfy both of them. There is a trade-off between competition (the market mechanism that forces banks to improve and adapt) and financial stability (what regulators want, which is to ensure that banks are strong enough to withstand market shocks). Operating efficiently can run counter to prudence and innovation. Innovation is risky and may threaten the bank's role as steward. Every action has trade-offs. No bank can be everything to everybody.

"The reality is like anything, you can only be loved by so many people at any one time. So, there is a danger you try to do so many things and try to be in so many different types of industries that actually that's how I

think you destroy yourself," cautions Steve Pateman, the head of corporate and commercial banking at Santander's UK corporate banking operation. "That's why you need a diversity of banks doing different things, genuinely different things, who are close to those different markets, so that people can choose." James Vaccaro, the head of market and corporate development at Triodos Bank, emphasises the importance of meeting the needs of different customers, "That's just good business development; it's not blue-sky thinking. It's really moving with society to create something useful." However, being focussed heavily on a single sector or geography is not without risk. Indeed traditional risk management has relied heavily on diversification. This tends to increase risk-weighted returns and make for more robust financial institutions.

effective, trustworthy and innovative **contradict** each other

	Effectiveness because:	Trustworthiness because:	Innovation because:
The effective bank conflicts with:		The more opaque the bank, the easier it is to extract profits from borrowers and depositors.	Effective banks have time-tested systems and business models. There is a bias towards the status quo.
The trustworthy bank conflicts with:	Following rules to the letter and setting aside large capital reserves reduces profits.		Innovations are often accompanied by new risks outside the experience of customers used to traditional ways.
The innovative bank conflicts with:	Innovation can be expensive and risky. A "me-too" strategy is not, at least in the short term.	Many innovations around financial engineering have relied on a lack of transparency to hide fees.	

These conflicts extend to the policy realm as well. Some universal banks are inherently complex and some that are "too big to fail" may also be too big to manage. By many accounts, these banks fail at effectiveness, posing a danger not just to them but to the entire financial system. Critics argue that giant banks should be broken up and replaced with a larger number of smaller banks, reducing risk both on the level of individual banks and the entire system. However, it is not at all clear that an effective bank cannot also be a large bank. These organisations are often key partners for the world's multinationals, enabling commerce to flow and businesses to invest. Indeed for Bob Lyddon, general secretary of IBOS Association, a London-based banking alliance, this is essential. "For corporates a good bank has to be international because the world is globalising. It has to have international reach," he states.

Crucially, banking carries inherent risks and changes to the size of the financial institutions is hardly a panacea. Breaking up big banks has been a solution offered by many, but "the flip side of too big to fail is too many to fail," says Giles Keating, the managing director and head of research for private banking and wealth management at Credit Suisse. Highlighting that smaller institutions failing en masse still carries

systemic risk, he says: "I don't believe that you can escape the impact of bank failures on society by some concept of diversity." While diversity can spread risk and, at times, better meet particular customer needs, it cannot on its own eliminate systemic risk. The failure of individual smaller institutions, as happened in the 1980s savings and loan crisis, carries less systemic risk, but addressing widespread bank failures becomes harder to coordinate as the number of players escalates. Mr Lyddon goes further, "I think it could actually be quite dangerous to get a lot of specialists in who pick off individual areas that they regard as more attractive. The whole point of a big bank is having lots of legs to stand on. If one isn't going well, the others support it." In reality, systemic risk is an inherent part of the financial system. This means different things for bankers, regulators and society at large.

As large, publically-held companies with an existing franchise, banks focus mostly on the first quality: effectiveness. Trustworthiness is often treated as a branding exercise. Innovation involves taking on new risks or entering businesses which are unproven, unsustainable or inefficient, so banks often adopt innovations only after they have been proven elsewhere.

the effective bank

**an effective
bank is here
today and
here tomorrow.**

This idea of longevity, of permanence, requires that banks serve the so-called “real” or non-financial economy. “An effective bank is one that serves the needs of the non-financial economy: deposits, payments, and lending”, says John Kay, a visiting professor of at the London School of Economics and a columnist for the Financial Times. “Unfortunately, those things are not being done well, and we have very large, complex institutions whose predominant activity is trading with each other.” From within its place in the real economy, the effective bank is profitable, efficient, manages risk well, operates under a clear set of rules, and pays attention to its customers.

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Start with the same principles as any business. To be effective, a bank needs a positive cash flow.

Peter Hahn, formerly a managing director at Citigroup, now at the Cass Business School in London

an effective bank is profitable

“Start with the same principles as any business,” says Peter Hahn, a former Citigroup managing director and now a faculty member at the Cass Business School in London. “To be effective, a bank needs a positive cash flow.” EIU survey research suggests that short-term profitability is the overriding goal for most financial services executives, confirming that Mr Hahn’s view is a majority one. Banks are private companies. If they did not make money for their owners, they would not exist. “Even non-profits need to generate positive return (they call this ‘change in net assets’). Saurabh Narain, chief executive of the National Community Investment Fund (NCIF, a non-profit private equity fund based in Chicago) affirms: “If your bank isn’t profitable, you can’t continue with your mission.”

Note that profitability does not equate to return on equity, which is directly correlated with leverage. As highlighted by one commenter on the online forum built to host The Good Bank, if return on equity (ROE) were a criteria, the most effective bank would be Iceland’s Kaupthing, which delivered 42% ROE (with

a AAA rating) the year before its collapse.² Indeed, a recent report from McKinsey found that the global average ROE is now at one-half of its peak value from before the financial crisis—and that, several of the panel members have argued, is a healthy development.

Profitability should also be seen from the perspective of shareholders and society, not just senior management. According to Mr Kay, even in pre-crisis times banks had effectively joined the not-for-profit sector, because profits accrued to management rather than owners. “From 2003 to 2008 they made money and paid it out to senior employees. Then they said it had been a mistake and put their hand out to the government to continue operating. I wish we were doing more to reform that structure and get back to a simple, basic, boring banking structure,” he says.

Profitability does not preclude the pursuit of other objectives. In fact, it is a prerequisite to the others—up to a point.



²See “The Good Bank” site at: <http://event.wavecastpro.com/thegoodbanklive/>

an effective bank puts a premium on risk management

Banks need to manage anticipated risks and hold capital against unanticipated risks. Banks that pay attention to sound risk management practices should not need to draw down their capital, except in dire circumstances.

Unfortunately, attention to risk follows a predictable cycle. Many banks have given chief risk officers more authority since the crisis. They have strengthened risk teams. They have re-thought models, aligning the assumptions to actual market behaviour. They have started to monitor forms of risk (such as liquidity and counterparty risks) that had previously received little attention. Stress testing has become a core risk management activity.

Yet it is still unclear whether the new focus on risk will survive should there be a serious upturn in the economy. "A problem with banks generally is setting an unrealistically high return on capital expectations—they often use 25%, a target set in the 1980s when inflation was 15%—and that requires

them to take on too much risk. They push themselves up the risk profile. Every two or three years they have a big credit loss and then their return on capital comes down," states Mr Lyddon, of IBOS Association. "So we've ended up in this cycle of boom and bust." If risk management is at its strongest when there is least need of it, then we are dealing with chronic myopia.

Mr Keating states: "Well-capitalised is not just about having a large chunk of equity capital. It is about having a very clear cascade down through the capital structure so that each investor at each level in the bank capital, from common equity up through depositors, understands the point at which they are all going to be on the hook for losses." In the past, this has not been the case. There has been insufficient clarity not only around the adequacy of capital, but around which investors absorb losses in which order.

The effective bank also takes its medicine quickly when the quality of its assets diminishes. "In Sweden, we forced banks to write down their losses on Eastern



European debt immediately,” says Martin Andersson, director general of the Swedish Financial Supervisory Authority (Finansinspektionen) and a former advisor to the Bank of England. “They said they would have to shrink their balance sheets. But they were able to turn around and lend to SMEs almost immediately—unlike in the UK, where banks were unwilling or couldn’t afford to clean up their balance sheets.”

An effective bank can recruit new customers and hold on to existing ones.

Banks have many stakeholders—investors, regulators, employees, society at large. But there is one group without whom banks would instantly cease to exist: customers. An effective bank should be able to offer customers reasons to come and reasons to stay. But there is a contradiction here. In a highly regulated industry environment dominated by a handful of giants, it is not always clear that there are sufficient incentives to provide the kind of service that keeps customers happy. “Banks have forgotten about their customers and now think more about their industry peers and themselves,” says Mr Andersson

In a competitive marketplace, holding on to customers requires a customer-centred way of thinking—an “outside-in” perspective. “What is depressing about discussions among financial services people is how self-referential they are,” says John Kay. “People talk to others in their own terminology without reference to underlying financial needs.”

An effective bank is efficient.

Historically banks have been big and complex. Complexity yields inefficiency. It is a legacy banks are struggling to overcome. The complexity of banks results from a legacy of low competition, high barriers to entry and complex organisational structures, fed by years of adding on product silos and acquired businesses. “If I’m the owner of the mortgage business and someone else is the owner of the credit card business, there’s no good way for us to make an offer available to customers without having an incredible amount of internal processes and internal transfer pricing,” says Don Trotta, SVP and global head of financial services industry development at SAP.

What has changed is that most banks have stopped getting bigger. While the largest institutions have actually increased their market share, the acquisitions have slowed. Banks can focus on simplification, automation and operational excellence. There will be more shared service centres to centralise activities and strip out duplication. IT infrastructure needs to become better integrated and more agile. Investment in data warehousing and analytics will help them to extract insights that can lead to better decisions. In the absence of constant restructurings, large banks can also be efficient banks.

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I think all organisations around the world talk about ‘customers must come first’. It’s part of the propaganda. But it doesn’t always get translated into decisions and actions.

Benny Higgins, CEO of Tesco Bank

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A problem with banks generally is setting an unrealistically high return on capital expectations—they often use 25%, a target set in the 1980s when inflation was 15%—and that requires them to take on too much risk.

Bob Lyddon, general secretary of the IBOS Association, a London-based banking alliance

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There’s always a degree of tension between the value you can give customers and value that shareholders demand or wish for. That is a balancing act.

Rhydian Lewis, Founder and CEO of RateSetter

“Most of all, banks need to be secure, transparent and act in their customers interests” Philip Augar, #TheGoodBank

Banks need to restore trust - especially among the younger generations. Is localism an option? asks @SharonBowlesMEP #TheGoodBank

“Lack of consumers switching banks is a problem not a positive,” responds @zopagiles to a question from the floor at #TheGoodBank



the trustworthy bank

Warren Buffet has said that it takes 20 years to build a reputation and five minutes to destroy it.

Banks have certainly had their five minutes. "There are real issues that will have to be addressed if banks are going to regain trust," says Sir Callum McCarthy, the former chairman of the UK Financial Services Authority. "I'm tempted to say that the expression 'trustworthy bank' will replace 'military intelligence' as the ultimate oxymoron."

"A good bank needs to be effective and a good bank needs to be innovative, but the core objective will always be to remain 100% trustworthy," says John Fullerton, founder and president of the Capital Institute. "And if banks had thought more carefully about that hierarchy, we would have gotten into a lot less trouble."

The five years since the start of the financial crisis have not passed without change. Banks have carried out significant reform, often motivated by regulatory requirements, in their lending and operations. Leverage ratios have improved—often well ahead of their regulatory mandates—and financial services companies have divested from risky, non-core functions. Risk management has increased markedly, along with equity capital. Despite these steps, much remains to be done for banking to rebuild the public's trust.

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The wrong starting question is, 'What is our target return on capital?' The right one is 'What products and services do our clients need?'

Philip Augar, a former equities broker and part of the team that negotiated the sale of Schroders to Citigroup

aligning incentives

The key issue is one of incentives: how to align the interests of bank management with those of customers over the intermediate to long term. In the 1960s and 70s, the then chief executive of US investment bank Goldman Sachs, Gus Levy, characterised its culture as “long-term greedy”, foregoing one-off sales of high-margin products in order to sustain client relationships over the long term. Incentives are skewed against the customers when managers are rewarded based on short-term profits and employees are rewarded on the basis of product commissions.

The problem is asymmetry of information. “The provider knows a great deal about what they’re selling and often the buyer doesn’t know very much about what they’re buying,” says Tesco Bank CEO Benny Higgins. “Often because of that information asymmetry, there is this notion that all banks are the same.” Clearly, as the experience of the last five years has shown, they are not.

Although it can be difficult to identify what clients need, “it’s actually not very difficult to identify the products he or she doesn’t need,” says Philip Augar, a former London equities broker and part of the team that negotiated the sale of Schroders to Citigroup. Examples abound, from Goldman Sachs’ short positions on securitised debt sold to investors, to the mortgage fraud practiced by HBOS in the UK and Countrywide in the US.

Mr Augar defines a trustworthy bank as having three qualities: secure, transparent, and acting in the best interests of the customer. Of the three, the most problematic is the conflict between banker and customer. “The wrong starting question is, ‘What is our target return on capital?’ says Mr Augar. “The right one is ‘What products and services do our clients need?’”

Historically, bankers started with what Mr Augar would call the wrong starting question: setting a return target based on peers. “If you’re looking at your business through the lens of profitability and profit maximisation, anything else that you do is going to look like a trade-off,” says Mr Vaccaro of Triodos Bank, a sustainable bank working for social, environmental and cultural change. “But that’s a natural outcome from initial assumptions. If you’re a hammer, the world looks like a bunch of nails.”

Moreover, this focus on profitability drives the businesses the bank lends to, the markets it enters and the values that come to permeate the organisation. “There was a mantra that if you want to make your career in this bank, it happens at the head office on the trading floor; it doesn’t happen at the branch,” says Mr Vaccaro. “That hasn’t gone away. The capital markets and the owners of banks still, fairly unashamedly, want the kinds of profits promised before the crisis. Fiduciary responsibility means acting in the best interests of the client; it does not mean creating profitability at the expense of massive systemic risk. All profits are not equal; money is not neutral. Profit can be earned through a relationship banking model in a responsible and sustainable way. And profit can be earned in a highly speculative and fundamentally unhealthy way.”

Nor is equity-based compensation more likely to drive a long-term, relationship-based business model. According to Sallie Krawcheck, a former president of the global wealth and investment management division of Bank of America, academic studies carried out since the financial crisis link equity compensation of senior management with financial distress. As of the end of 2006, financial executives with the biggest equity stakes were Bear Stearns’ James Cayne, Lehman Brothers’ Richard Fuld, Merrill Lynch’s Stan O’Neal, Countrywide’s Angelo Mozilo and Corus Bankshares’ Robert J. Glickman. All of these institutions crashed and burned during the crisis.³

An example from another industry may be informative. “I did some work once for Tesco,” says Giles Andrews, co-founder of a peer-to-peer lending platform, Zopa. “When a new proposition was brought to the company at any level—from buyers up to the board—the first question that was asked was, ‘What’s in it for the consumer? Where’s the value in what you bring to the consumer?’ If that question was answered satisfactorily they might then say, ‘Can we provide the best value in the market?’ The third question was, ‘Can we make money?’ And if the first two were unsatisfied, the third one was never even discussed. That’s not the culture in banks.”

³“Four Ways to Fix Banks,” Harvard Business Review, June 2012

compliance as a path to trust

Following the rules isn't the same as acting in the interests of customers and building trust, but it is a start. Compliance is the baseline. But there are four problems with compliance. First, compliance is difficult and expensive. Because the rules have become more complex, banks must allocate more resources than they did before the financial crisis. Second, even banks that follow the rules to the letter may find ways to circumvent their intent. There is always a conflict between what bankers want to do and what regulators want them to do. Third, regulators sometimes make mistakes. When they do, the public suffers, and banks take two steps back in the public's perception. And most important, rules are no substitute for thoughtful behaviour aimed at keeping the financial ecosystem in balance.

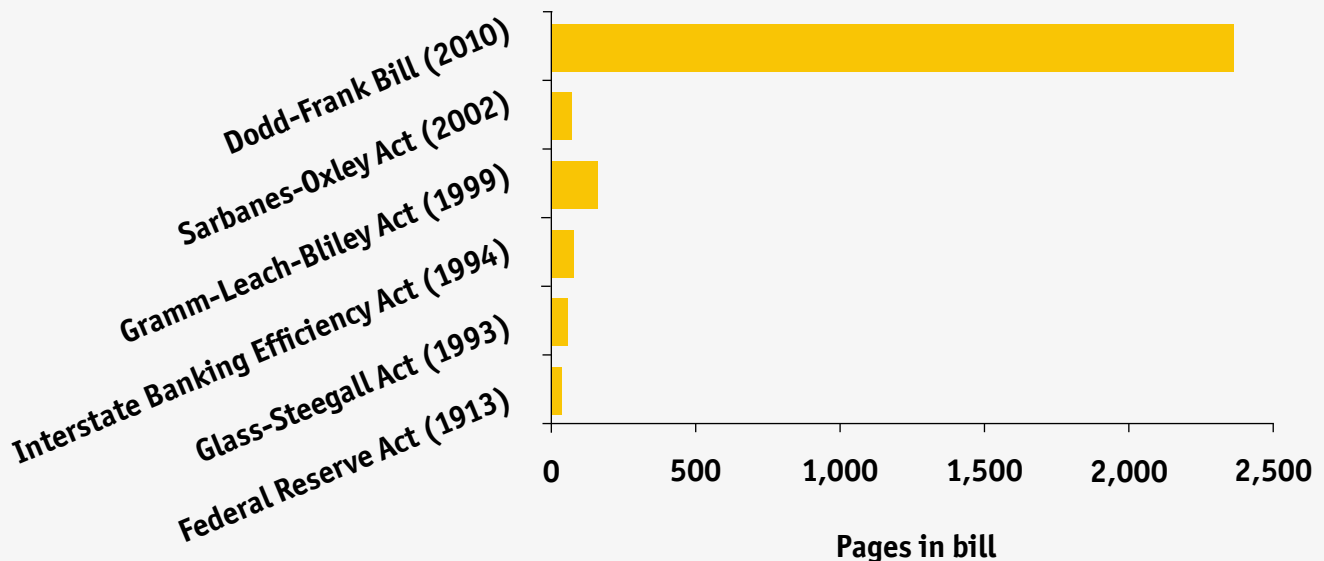
Steve Brecher, a partner at WeiserMazars, highlights the challenging environment. "Banks are faced with the need to attract top flight talent in an environment

where there is pressure, legal or otherwise, to cap executive pay, as well as the obligation to provide lending and liquidity to the marketplace, while faced with these regulatory pressures. They need to do all this while simultaneously enhancing shareholder value. This balancing act has to be maintained in equilibrium while banks work to rebuild clients' trust."

Compliance is difficult and expensive.

One consequence of breakdown is the exponential growth in bank regulation. According to some reports, banks are allocating 25% of their budgets on compliance with overseas regulations. There are over 9,000 pages in the Dodd-Frank financial services bill, and the regulations—still being written—will run far longer. However, even if banks could comply with the vast new layer of regulation, it would not address the underlying issue that the rules are intended to address: the sense that banks cannot be trusted to act in society's best interests.

length of major US financial services bills





There will always be pressure between the industry and the government about the level of capital and the size of the liquidity buffers.

Martin Andersson, former head of the Financial Stability Department of Sweden's central bank

Banks have an incentive to take on too much risk.

There is an asymmetry between society and banks with regard to capital. When society is the backstop to the system, the market mechanism does not work. "There's no interest from the national bank lobby to have good quality capital. If I'm a banker, I want the lowest possible level of capital and the lowest quality capital," says Martin Andersson, former head of the Financial Stability Department of the Riksbank (Sweden's central bank) and adviser to the Bank of England. "There will always be pressure between the industry and the government about the level of capital and the size of the liquidity buffers."

There is also disagreement about how the level of capital is measured. "The off-balance-sheet exposures don't get adequately measured in the traditional metrics. You have to look at what's on the balance sheet and what's off the balance sheet and tie both to the level of capital you deploy, the businesses that you manage and what kind of coverage you have," says Prasad Chintamaneni, the senior vice-president and head of global markets for Cognizant's banking and financial services practice.

Regulators make mistakes.

Remember that central banks and regulators facilitated a prolonged period of loose monetary policy and oversaw the expansion of credit that culminated in the global financial crisis. These institutions share responsibility with the banks themselves. Whether this is because of excessive faith in markets' ability to self-regulate, or insufficient resources and foresight,

is a contentious question. Suffice to highlight that this fallibility has significant consequences for the wider public, as well as the financial sector. As a result, even stringent re-regulation cannot guarantee security nor obviate the need for banks to exercise prudence.

Capital buffers and leverage ratios are a key example of the trade-offs involved. While capital requirements are rising markedly across the developed world, this is taking place in the context of a lengthy recession and a still weak recovery. Bankers and regulators need to strike a balance between encouraging economic growth and keeping credit growth responsible.

Furthermore, since capital requirements discourage new entrants, there is a trade-off between capital and competition, with regulators sometimes erring on the side of insufficient capital. "In Sweden we had lots of ideas to foster competition by allowing lightly capitalised companies," says Mr Andersson. "They all ended up being damaging for consumers."

IBOS's Mr Lyddon offers an analogy, referring to minimally capitalised new entrants in the UK banking market called "payment institutions" and "eMoney institutions," which are allowed to start up with as little as €350,000 in capital. "Imagine that you answer your doorbell and see a 17-year-old boy. He says, 'That's a nice BMW you've got on the drive. I'd like to drive it. Look, I just passed my test, here's my full licence, so just go and phone your insurance company, put me on as a named driver, give me the keys and I'll be off.' Would you give the boy your keys?" asks Mr Lyddon.

IN A RECENT YOUNG SURVEY
OF MORE THAN 1,000 STUDENTS

41%
DISTRUSTED
BANKS AND
FINANCIAL
SERVICES
PROVIDERS

YOUNG POLL CONDUCTED ON BEHALF
OF LLOYDS BANKING GROUP

the idea of “duty of care”

The alignment of banker and customer interests requires changes on the part of both bankers and customers. For bankers, it requires a code of ethics backed by controls and incentives, at some level even personal liability. For customers, it requires an understanding and acceptance of risk. Shareholders in financial services companies also need to adjust; short-termism and unrealistic expectations must be tempered.

“In terms of things to restore trust, we’ve got to have stronger controls within banks,” says Mr McCarthy.

“We need something akin to a Hippocratic Oath for bankers based on the notion of ‘do no harm,’” states Sharon Margaret Bowles, a UK member of the European Parliament, shortlisted in 2012 to be governor of the Bank of England. “Doctors have a duty of care to wider society. If they have a disease, they are obligated to notify. If you ask lawyers in a bank who they are

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We need to go back to the time when people were personally liable. Would we be jailing more bankers? Probably. Currently there is an idea that regulations are there to be gamed. Gaming the regulation has to be a sin. With punishment.

Sharon Margaret Bowles, a UK member of the European Parliament

We lost track of the reality that banks have a special privilege and responsibility for the role they play in a sound economy.

John Fullerton, founder of the Capital Institute

I think the problem is a mixture of wrong incentives, insufficient training combined with limited personal liability.

Senta Penner, member of the Supervisory Board of Euram Bank AG

servicing, they don’t consider that they have a wider duty to society. They only have a duty to deliver to their client, who could be internal to the bank. We need to go back to the time when people were personally liable. Would we be jailing more bankers? Probably. Currently there is an idea that regulations are there to be gamed. Gaming the regulation has to be a sin. With punishment.”

But bank customers should not be free from responsibility either. “It used to be the view that if you behave and gave people full, fair, and complete information, you could discharge responsibility,” says Mr McCarthy. “That doesn’t work in a country in which 20% of adults don’t understand percentages. How do you sell a financial product to that sort of person? If you then say that you cannot rely on caveat emptor, except for a tiny proportion of the population, how does the bank put its customers’ interests first?”

a wider social role for banks

At their core, banks link savers and investors, and society looks to bankers to perform this role admirably. Facilitating growth—and ultimately increased prosperity—across the wider economy should be central to the value of financial services. Indeed, in growth-starved Europe for example, much of the anger directed at banks has resulted from the cost of bailouts. However, “The anger now is about the lack of credit supply”, states Jonathan McMahon, Global Head of Regulation and Bank Restructuring at Mazars.

Mr McMahon cites the case of Ireland as instructive, where, like many developed markets, banking has shifted wholesale towards lending against property in place of business lending. In this over-reliance on real estate, “a whole generation of skill was lost in basic banking skills”. Rather than assessing business ventures’ cash flow and credit risk, the property bubble became a leading driver of credit creation. Fortunately, despite this legacy of over reliance on property lending, Mr McMahon is optimistic about banks’ ability towards cash-flow based SME lending. “It is about management directing people towards those activities,” he says. There are signs that banks have been moving in this direction in recent years, but how fast this happens remains an open question.

The growth of business lending, despite the challenges this poses, is key both to economic recovery and to rebuilding trust in the banking industry. At its core the question is, “Are banks going to be able to create the new assets that the economy needs?”, asks Mr McMahon.

“Until that happens it is going to be very difficult for banks to win people around.”

Ultimately, people trust organisations that behave in admirable ways.

As a result, the most trusted banks may be those that commit to a wider social role, such as Triodos Bank, mission-oriented banks funded by the National Community Investment Fund (NCIF) like Carver FSB, or microlender Grameen Bank (whose founder, Muhammad Yunus, won the 2006 Nobel Peace Prize).

All of these institutions have found ways to reconcile social goals with the pursuit of profit. They do so by changing the definition of return. “The total return equation only takes into account financial return,” says Mr Narain. “If you change the definition of ‘return’ to include the impact on the real economy, you will have better asset-allocation decisions. For me, IRR isn’t internal rate of return; instead the ‘i’ stands for impact, as in social impact and environmental impact, ‘r’ stands for risk and ‘r’ stands for total return.”

Mr Vaccaro also offers a broader definition of return. “Fiduciary responsibility is not only about profit maximisation; the definition of the term is ‘to act in the best interests of the shareholders,’” he affirms. “Acting in their best interests has been reduced to profitability in the same way as all things in the financial services sector have been commoditised. It is not necessary to create business models that will create profitability at the expense of massive systemic risk.”

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the innovative bank

The word innovation brings to mind digital technology;

specifically social, mobile, cloud, analytics and big data. In terms of companies, innovation brings to mind the “four horsemen of the internet”—Google, Facebook, Amazon and Apple—as well as multitudes of start-ups. Often these companies are paired with industries that they have disrupted, such as publishing, music and retail.

Innovation in banking has different and often less benign associations. Many banking innovations have destroyed value or at least failed to add any. Structured securities masked risk behind a veil of complexity. High-frequency trading enriches a handful of algorithmic traders at the expense of other market participants. Complex derivatives fuelled the overconfidence of quants who believed that they could put a precise number on risk, and who found an audience within bank management only too willing to believe them. The automation of credit decisions removed human judgment so completely from the evaluation, that it led to misallocation of capital and severed the relationships of banks and their communities.

These innovations frequently have negative externalities. Investing billions of US dollars in optical cables for the purpose of allowing high-frequency traders to shave nanoseconds off execution provides little discernible social benefit. According to Mr Vaccaro, it is “pulling brilliant people into an arbitrage that spins secondary securities and creates nothing. We have big problems that they could be

working on instead: food security, energy security, new social business models. Financial services is a tragedy in terms of the loss of human capital”.

This perspective is by no means uncontested within the banking industry. Mr Keating takes the long view, stating: “Financial traders have paid to refine the technology of optical cabling to near light speed. Maybe that gets used in hospitals, in communications, who knows?” He argues that “we need to wait to judge its real value”.

The technology- and analytics-led innovations in retailing, publishing, and music have a common theme: they have all empowered consumers, who now shop, read, and entertain themselves in ways unimagined even 15 years ago. In fact, these innovations can make banks look worse than they used to. In some ways however, this is a measure of how ubiquitous certain improvements have already become. Accordingly, Mr Keating affirms, “I can use the same bit of plastic to pay for lunch in Beijing, Brighton and Bahrain. I can manage, analyse and change my investments online at the click of a mouse. So banking clearly has produced good innovations—as well as not so good ones, like any industry. Right now there is a tendency to focus only on the not so good ones.”

Over time, the good bank has found myriad new and better ways to deliver value, whether through technology, analytics, or other forms of invention. If products and services fail to improve over time in a market economy, incumbents are replaced by competitors. For instance, no bank can survive today without offering online account management, mobile payments, e-signatures, or image recognition of cheques. These innovations have become a new baseline.



I can use the same bit of plastic to pay for lunch in Beijing, Brighton and Bahrain. I can manage, analyse and change my investments online at the click of a mouse.

Giles Keating, managing director and head of research for private banking and wealth management at Credit Suisse.

“The expectation nowadays is that people are able to do things quickly and easily, with multiple points of access—to me that falls more into the effective bucket than the trust bucket, in the sense that you need to be able to deliver your product in a seamless way across different platforms in order to be effective,” says Rhydian Lewis, founder and CEO of a peer-to-peer lending platform, RateSetter. “Banks that can’t do that get a big thumbs-down. That’s quite a challenge for big institutions with legacy systems. They’re trying very hard to make that transition.”

This is an area where the effective bank could use some help from the innovative bank. Malcolm Frank, the executive vice-president of strategy and

marketing at Cognizant, tells a story about the US television show Cheers, about a bar in Boston. The tagline of Cheers was, “Where everybody knows your name”. But when consumers go to the website of Amazon, an e-commerce company, Mr Frank points out that the company knows their name, address, credit card number and everything they have ever bought. Retail banking may want to be like Cheers, but in fact customer service is very impersonal by Amazon’s standards. Meanwhile, Amazon’s virtual customer intimacy is incredibly personal, but involves no personal contact. Millennials will soon be the dominant customer group in the West—and they tend to prefer Amazon’s approach.

**MORE THAN 40%
OF BANKS ARE WORKING
TO BOOST THEIR STRATEGIES
FOR BIG DATA, ANALYTICS
AND DATA COLLECTION.**

(DC FINANCIAL INSIGHTS)

a new era of banking innovation



In fact, the post-crisis banking industry is undergoing a surge in innovations. Some are behind the scenes, in the back office of large banks. Some are enabling new entrants going after niche segments, peeling off customers with specific values and needs. Social media is supporting communities of like-minded customers. Some of the innovation is around systems aimed at helping banks shift from a product orientation to a relationship orientation, for the benefit of both providers and customers.

The vast majority of banking innovations involve servicing precise groups of inadequately served depositors, borrowers or customers in need of transaction services. Any business that understands its customer segment sufficiently well enough to come up with a highly targeted offering, can peel away a sliver of customers. Similarly, any business with the requisite relationships in place can now leverage those relationships to get into the banking business. Multiply that phenomenon by a rising selection of new market entrants and the core business of banking incumbents needs to adapt.

“

Search engines and online merchants are already expert in aggregating and examining millions of customers and billions of interactions, to find connections and similarities that can be brought back down to add value at the individual level.

Don Trotta, SVP and global head of financial services industry development at SAP

Helping the new entrants is the fact that many legacy banks are hampered by negative brand baggage. A business that can reach a large audience of potential customers—on either the borrower or lender side—has at least the possibility of entering a financial services business.

Wal-Mart, and other retailers, with access to a large number of shoppers, are offering store value cards as alternatives for consumers wishing to cash paycheques. On the investor side, crowdfunding has been used to raise funding for start-ups, motion pictures, software and a plethora of inventions. According to Carla Antunes da Silva, head of European banks at Credit Suisse, “The crowdfunding market is still negligible relative to global lending and capital markets. On a global scale, only about US\$9.5bn of credit and equity are crowdfunded, out of multi-trillion market globally. Growth in crowdfunding is nevertheless driven by its pricing advantage, banks’ lending restrictions and damaged reputations, as well as client demand.”

The growth of crowdfunding suggests there is another reason why innovation is flourishing: scale is not as important as it used to be. Mr Andrews, of peer-to-peer lending platform Zopa, points out that “scale can be an advantage, but it can also be a major disadvantage.

For new entrants trying to tackle incumbents, you have the advantage of being able to move much faster and you don’t have the organisational overhead that can interfere with a simpler and more innovative strategy”.

Technology is helping to target a wide range of micro-segments. The internet makes it easy to find, pursue and capture distinct customer segments. Affinity networks—clusters of people who self-organise around common interests or traits—are distinct segments already. Says Mr Andrews: “In terms of reach within a territory, I think one of our great strengths is the narrowness of our focus. We can capture a big share of a narrow product.

In the future other people will attack other narrow bits of banking.” This “long-tail” approach, the pursuit of micro-segments, is facilitated greatly by the ability to extract common patterns and needs from consumer behaviour on the internet.

“Search engines and online merchants are already experts in aggregating and examining millions of customers and billions of interactions to find connections and similarities that can be brought back down to add value at the individual level,” says SAP’s Mr Trotta



Clearly, mobile banking and its bigger sibling smartphone banking are reshaping retail and SME interfaces for banking. What’s yet to take hold is the transformation of digital bank services brought over from analog eras.

Bruce Cahan, CEO and founder of Urban Logic

Banking is really moving into mobile and other technology platforms. So what will be true innovation is when we can find ways of switching financial products and services on these platforms while retaining the stickiness associated with banks and relationships.

Saurabn Narain, chief executive of the National Community Investment Fund



building something new... and better...

Apps engage customers and build loyalty.

Mint.com was an early service offering simple charts of progress towards financial goals. National Australia Bank's "Money Tracker" and Barclays' "Money Tools" are more recent manifestations of the same idea. An app designed to appeal to values-driven customers is Triodos Bank's "Know Where Your Money Goes" tool. Mr Vaccaro explains: "Not only can you find out how much money you've got, but you can see the interactive map of every loan we make in The Netherlands, so as you're cycling around you can see who is benefitting from your participation with the bank." Ultimately, the app may influence policy decisions. "If people know where we lend, we're going to have to think about where we lend—and that will start influencing the direction of credit decisions," says Mr Vaccaro. "If replicated by all banks across the country, then those questions may force policy decisions in certain areas and allow regulators to have more of a dialogue."

Social media is bringing together communities and financial advisors.

One of the more compelling innovations among financial advisory firms is bringing together a community of high-net-worth clients on a virtual platform, such as a private social media network, to exchange ideas with financial advisors. The people are in a similar age bracket and have a similar net worth profile. "The clients get a lot more out of it than a financial advisor doing a passive allocation

strategy and saying, 'Hey, you are 40 years old so you should have so much in equities and bonds and cash and gold,'" says Cognizant's Mr Chintamaneni. "Here they talk to their peers, facilitated by the financial advisors. This is becoming a very powerful way of building a virtual client community and it sparks a stronger sense of loyalty. For the financial institution, the unstructured data from social channels is a potential goldmine of intelligence."

Technology is bringing wealth management to the masses.

Legacy wealth managers such as Goldman Sachs and JPMorgan have been joined by online names such as Wealthfront, MarketRiders and Personal Capital. All use technology to build customised asset portfolios at a cost far below that of their traditional peers. Wealthfront uses algorithmic strategies based on the client's risk tolerance to manage money for 25 basis points annually. Personal Capital, started by the former CEO of PayPal and Intuit, provides portfolio and tax-management advice to customers who sign up online. MarketRiders charges \$14.95 a month to estimate the client's risk tolerance and build a portfolio of exchange-traded funds (ETFs), rebalance them quarterly, that the client can buy through any broker. A company called Betterment charges 15 basis points annually for a similar service. The onslaught of new companies is driving down fees and increasing transparency.

Banks finally have the means to become customer centric.

A recent global survey by Capgemini Financial Services shows that only 33% of bank customers believe that their bank has knowledge of their needs and preferences. Many customers want to change banks, but it is difficult to switch. "They switch in the telecoms and energy industries," says SAP's Mr Trotta. "I think that's a signal of the health of those industries. Those industries are trusted because consumers know that they can move if they're unhappy. Whereas with banks, it's very difficult to switch."

But banks now have the means to know their mass market customers much better—and to deliver more personalised service than ever before. It has always been available to the high net worth customer, but because of all the different sources of data that people can look at now, it is possible to assemble a picture for the customer that says, "this is how you're spending your money. If you want to buy a house, budget it like this; if you want to send your children to college, here's how to do it".

“

If you look at the younger demographic, people in their 20s and 30s, the expectation of how you interact with a financial services company is changing rapidly.

Rhydian Lewis, founder and CEO of RateSetter

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Don Trotta, SVP and global head of financial services industry development at SAP

The future of retail banking is mobile says Capgemini vice-president, Samir Kamat, on <http://www.thegoodbankdebate.com/> #TheGoodBank



Banks are innovating in loan structures.

Financial engineering has a bad name for good reasons. The quants who sliced and reassembled risk destroyed immense value when markets contradicted the assumptions embedded in their models. But financial engineering lives on; it is finding new areas to explore and ways to redeem itself. "Securitisation, as an idea, as an innovation, is a good innovation but it needs to be managed responsibly," states Mr Fullerton.

Andrew Lo, the director of the laboratory for financial engineering at the Massachusetts Institute of Technology (MIT), is driving a project to develop "research-based obligations"—RBO bonds—collateralised by payoffs from cancer-drug research at different stages in the development pipeline: high risk in the early stages and progressively less risky as drug trials advance. Financial engineers contributed to the "vaccine bonds" that helped the International Finance Facility for Immunisation, by leveraging government pledges to finance African immunisation programmes.

A similar system has evolved in China on an e-commerce site, Alibaba, which hosts millions of SMEs selling to hundreds of millions of consumers. Many of those SMEs need bank loans. Because lenders can see the transactions that are going on every day, the SMEs can get loans from the Chinese banks where they were not able to do so before. "They've actually built a new lending model," says Ann Cairns, the president of international markets for MasterCard Worldwide. "It's a new lending model based on empirical data."

trust and technology working towards the good bank

at the start of this paper, banks were unfavourably compared with smartphones.

It is easy to see how smartphones are getting better every year. But it is harder to see how banks are improving. But there is reason to believe that they are improving—and at the deep level of the business model, rather than front-office cosmetics or marketing exercises.

The entrance of new competitors into financial services is ultimately a healthy process, as the market adapts to meet customer needs. Jonathan McMahon strikes a positive note, “Over time there will be a restoration of the industry. Oddly enough, probably helped by firms like Zopa and others: creating competition, keeping people on their toes. Competition ultimately is going to be the best force here. It won’t be governments, it won’t be regulators, it won’t be politicians. It will be competition that drives the standards and improvements.” These improvements are taking shape globally to rebuild banking as an institution at the heart of wider economic growth. Many banks are strengthening their balance sheets, entering new market segments and adapting, albeit slowly at times, to the challenges facing their industry.

For many, banking is starting to function as a platform, bringing in specialised partners. Think of the auto industry. Many car manufacturers no longer manufacture cars. Instead, they focus on design and managing the brand, while subcontracting out most of the actual manufacturing. Assuming that banks are good at design and brand management, this could also be the model for banking.

An example is the decision by Santander to offer cars for lease. Santander didn’t have any expertise in cars, just car financing. So it partnered with a company called Zenith that specialises in providing and maintaining cars. “We provide the money, they look after the cars, and it works perfectly well,” says Mr Pateman at Santander. “We got the product up and running get in three to four months, while building

it without partnering could have taken many years. We’re not thinking, ‘I’ve got to own in it all.’ We don’t have to be them. We’ll work with them.”

Ms Cairns explains how the partnering and collaboration approach works in the payments space. “The whole model of how we work together is built on outsourcing. We’re working with banks on the payments and smaller companies to develop the dongles and mobile card readers. That’s disruptive technology, because now SMEs don’t need to buy expensive terminals, they can get telephones, plug these things in and suddenly they can operate by receiving cards and so, a new form of payment for them. So all of the different players have a role in the ecosystem.”

Instead of doing it all, banks are becoming role players in a much larger network. “Banks need to be able to plug in to other partners in systems without all of that systems integration work taking place,” says Mr Trotta. “Banks are starting to standardise their core processes. There’s a real opportunity to change this proprietary ‘we do it all ourselves and we’re always different’ approach.”

One analogy lies with the cloud servers that form the core of the internet. Banks are becoming central platforms, linked via APIs (platforms organising how software components interact) to partners throughout the broader network. And not just in the developed world. In fact, nowhere is this new model likely to have a more profound impact than among the 50% of the world’s adults who have no bank account.⁵ In terms of the greatest good for the greatest number, this is the critical outcome of the bank as platform: a good bank for those who now have no bank.

As an example, Standard Bank of South Africa now sends staff with smartphones to rural South Africa, photographing identity documents and remotely

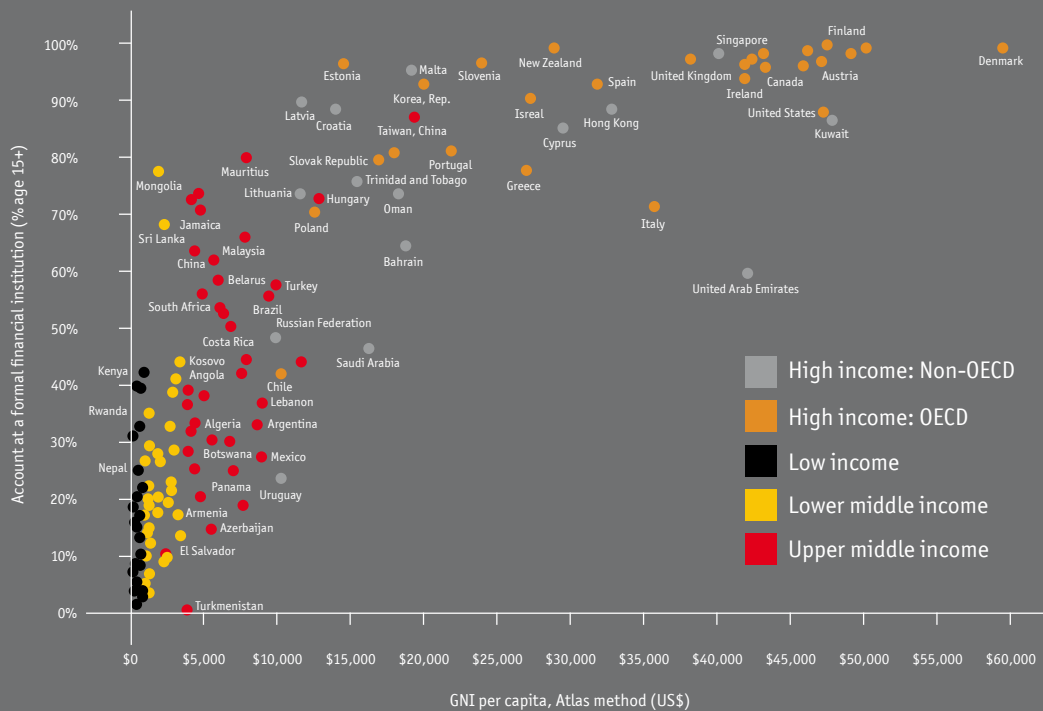


Competition ultimately is going to be the best force here. It won’t be governments; it won’t be regulators; it won’t be politicians. It will be competition that drives the standards and improvements.

Jonathan McMahon, global head of regulation and bank restructuring at Mazars

the world's unbanked

GNI in current US\$ vs percent of population with a bank account



activating bank accounts. The owners of the accounts can manage their money using a mixture of phone banking, text messaging and in-person transactions at local stores. There are about 12m unbanked and underbanked South Africans who, using services like these, may now be able to save for the future, transfer funds to family members and avoid the risks associated with cash. A similar initiative is underway in Bangladesh, where Dutch Bangla Bank is combining mobile services, internet banking and ATMs to build a banking model around a “mobile account”, into which employers can pay salaries directly.

It is unlikely that banks will earn much from this endeavour in the short term. But the long term is a different matter. A good banking partner can help the poor edge into the middle class. And the ability to offer very low-cost services, often to customers that will never set foot inside of a bank branch, requires an inventive combination of people, process and technology that will have positive spillover effects on other parts of the bank (not to mention society at large).

An advantage of emerging markets is the lack of legacy infrastructure, which provides a blank slate for new technology. “We’ve just rolled out a huge biometric solution to do benefits payments across South Africa,” says Ms Cairns. “One-fifth of the population is now receiving their benefits electronically on a card, they can use it to buy food and they use fingerprint

and voice recognition for that.” And since banks must be part of the payments system in order for it to work, they will always have a big role in these payments, regardless of the technology used. “We’ve seen telecoms companies try to launch payment businesses in countries. It hasn’t worked. People want safe, simple and smart solutions. When it comes to safety and protection against fraud, people look to banks.”

“The role of banking is evolving and many of the products and services are getting unbundled. Whether it is payment services, mobile banking or lending, many more services will be offered by independent providers. You can even have a centralised back-office infrastructure so that banks don’t have to worry the operations - they need to concentrate on local, on-the-ground customer relationships and stakeholder engagement - much like a franchisor-franchisee model. It may happen in five years or it may take longer, but it will happen.”

“The point,” says Mr Narain, “is that when all of the pieces are unbundled, you need an aggregator of trust to stand in the middle. The bank is an aggregator of trust - an aggregator of products and services from a trustworthy source.”

⁵World Bank financial inclusion data, <http://datatopics.worldbank.org/financialinclusion/#>, 2011 estimate.

conclusion: which comes first?

All three characteristics of the good bank—being effective, trustworthy and innovative—are important. But are all equally critical? No. One quality clearly stands above the rest.

“Trust is the most important quality,” says Rate Setter’s Mr Lewis. “Without trust, there is nothing else,” concurs Mr Chintamaneni of Cognizant. “If you are not trustworthy, nothing else matters, because you are the glue that keeps the whole ecosystem together. It is your role to facilitate and foster economic interactions.”

When we look for a bank or financial institution, trustworthiness is the top attribute. But while trust is necessary, it is not sufficient. “Once you are a trustworthy institution promoting the ecosystem, effectiveness becomes important,” says Mr Chintamaneni. “It is important in terms of how you manage your operations, in terms of how you interact with your partners, in terms of how you keep your clients satisfied and deliver on your commitments.” Indeed, trust isn’t possible without some degree of effectiveness. Trust is about sincerity and honesty; effectiveness is about delivering on promises and commitments.

Innovation is more important in the intermediate to long term, but trust is always the foundation. “While there are degrees of effectiveness and innovation, trust is binary: either you are trustworthy or you are not. “Trustworthiness is the most important thing in business. It emanates from good people, as much as it does from good systems and regulation. In the end it’s people that run businesses and banks, and they need to be trustworthy,” says Mr Lewis.

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