Driving profitability in a low-rate world

The state of the banking industry

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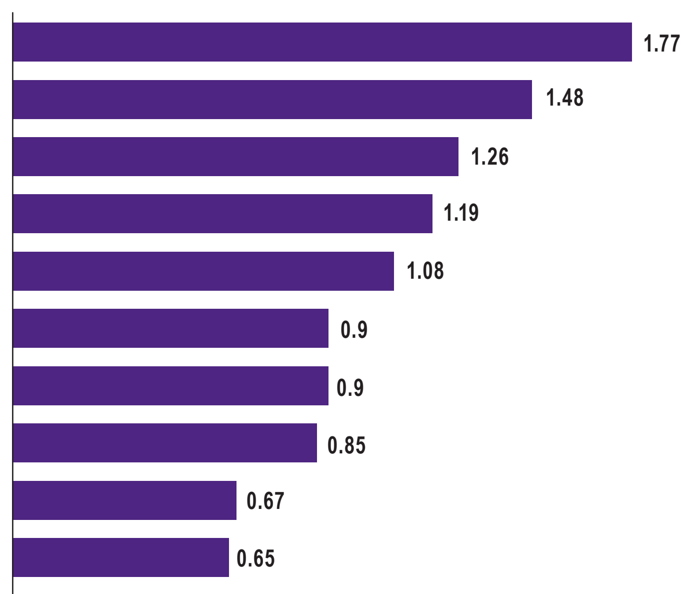
Nigel Smith, Grant Thornton LLP's national Financial Services leader

Powerful trends are converging on the banking industry with a combined force that is shaking the sector to its core.

Compression of net interest margin is now a structural issue for the industry. While the U.S. Federal Reserve Board moved beyond its zero interest-rate policy in 2016, rate increases have been slow and, from the banks' perspective, frustratingly small. Five major central banks in Europe and Asia are trying to move their economic needles with below-zero rates.

The regulatory changes that followed the financial crisis materially increased the cost of compliance. However, in the long term, the impact of altered capital requirements on profitability and, hence, the business portfolio may prove more consequential. Additional disruptive forces include a changing competitive environment and new frontiers in technology.

Half of the 10 largest U.S. banks have price-to-book ratios of less than 1



Source: Financial Information Systems, June 2016
Price-to-book ratios for the 10 largest banks by asset under management

"In this environment, even the best-run banks are challenged to deliver a satisfactory return on equity," observed Nigel Smith, Grant Thornton LLP's national Financial Services leader. "And a disturbing number of the largest banks are worth more on paper than their share values reflect — a situation that's clearly unsustainable."

Banks have already gone through multiple rounds of cost cutting, but they must also address the fundamental complexities in their business models to drive profitability in the current low-rate environment. This is a tough challenge. Since opportunities for top-line growth are scarce, the ability to invest in the required transformation is significantly reduced.

How should banks respond to these challenges? As our banking clients plan for and enter 2017, we urge them to take the following actions.

Drive simplification throughout the business model

Most banks have very complex operating models, with multiple processes and highly customized IT systems. Many U.S. banks, in contrast to their European peers, organize around products, such as credit cards or mortgages. This creates duplication and lack of accountability for total aggregate costs. U.S. banks tend to operate in product and channel silos, duplicating processes and missing opportunities to integrate data. This may be at least in part a failure to fully integrate previous acquisitions. In other cases, it may be the result of allowing individual businesses too much autonomy in their operations and technology.

In addition, there has been a steady increase in the number of channels, including digital and social media. These may have been bolted on to existing solutions rather than legacy solutions re-engineered or upgraded to address the new omnichannel reality. This often results in fragmented middle- and back-office operations, and lower productivity. Traditional cost-saving approaches — often focused on tightening procurement and reducing headcount — eventually hit diminishing returns when confronted with this complexity.

These conditions contribute to customer frustration and real competitive risk. New market entrants can design a simpler, more intuitive customer experience from scratch, leveraging digital channels from the outset with a once-and-done approach to capturing data.

Banks need to radically simplify their operating models, starting with the markets and customer segments they serve. Eliminating unnecessary products and features can in itself be a major driver of increased efficiency. Product rationalization creates a multiplier effect through reduction in the associated costs of marketing, training, reporting and other administration.

Moving to a rationalized set of operations and IT platforms is a tougher proposition, but is critical to drive out complexity and increase productivity. Given the spider web of existing architectures and interfaces, some banks may need to consider ring-fencing existing platforms while building new foundations. In fact, some banks used a variant of this good bank, bad bank approach for asset restructuring. There will be additional benefits arising from that simplification as time to market can be reduced and total cost of ownership falls.

None of the previously mentioned ideas are straightforward, but each is critical to achieving sustainable long-term profitability.

Invest in compliance optimization

The challenges of keeping up with the Dodd-Frank Wall Street Reform and Consumer Protection Act (including the Volcker Rule), mandates from the Consumer Financial Protection Bureau, stress tests, capital requirements, and so on dominate boardroom conversations at leading banks, often at the expense of product and service innovation. The aggregate cost of compliance across all three lines of defense (business operations, risk management and compliance, and internal audit) now represents a material and often growing share of noninterest expense.

So while banks are focusing on risk and regulatory compliance, new and unconventional competitors are bringing to market similar products and services to meet customers' needs, usually without the same regulatory burden.

Regulations aren't going away, but banks of all sizes have ample opportunity to comply with them more efficiently and effectively. According to Jose Molina, a principal in Grant Thornton's Financial Services Advisory practice, the opportunity for banks lies in reducing costs for activities that don't add value and refocusing their compliance teams to provide a competitive advantage.

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"Many regulatory and associated reporting solutions were implemented in a hurry, to meet mandatory deadlines, and would certainly benefit from end-to-end process re-engineering, reducing duplication and driving productivity," Molina commented. "At the same time, increased use of risk-based approaches, coupled with machine learning and analytics, can be leveraged to automate repetitive tasks and leverage human intervention where it will most reduce risk."

A recent Grant Thornton survey of corporate governance, risk and compliance (GRC) functions — including nearly 100 banks of all sizes — bears out Molina's perspective:

- Nearly two-thirds of banking respondents are enhancing GRC activities by focusing more on risk management, and roughly half mentioned refining/improving existing enterprise risk management.
- More than 40% are implementing data analytics and risk modeling.
- More than two-thirds indicated that without existing constraints, their internal audit functions could add value to identifying improvement opportunities.
- More than a third are integrating GRC into their operations and business strategy.

Others are pushing the envelope further, leveraging cross-bank "utilities" to drive economies of scale at an industry level (see "Explore industry utilities").

Explore industry utilities

On the innovation front, a number of leading banks are reaching outside their institutions, establishing cross-industry utilities to address core functions that are not a source of competitive advantage. Banks are looking at all their nonstrategic processes as the industry aims to operate in a fundamentally simpler way. Initial utility forays in banking include vital yet time-consuming administrative functions, such as client screening and third-party risk assessment and monitoring.

The benefits are undeniable. For banks, the high volumes and innovative systems of these independent utilities lower costs, increase efficiency and improve performance. In some cases, the ability to look at risk and potential fraud across the industry may also enhance the collective ability to respond to threats.

Benefits accrue to third parties as well. For example, industry suppliers need to respond to just one monitoring organization for most (if not all) of their banking clients. The burden of multiple responses and different reporting criteria is reduced, allowing suppliers to work more efficiently and pass savings to their banking customers.

"The banking sector has been exploring the benefits of collaborative utilities for many years now," explained Dennis Frio, managing director in Grant Thornton's Financial Services Advisory practice. "We see the model already extending to relieve the regulatory burden in areas such as Know Your Customer and Know Your Third Party consortiums."

Identify value-added services

In addition to simplifying products and services, banks need to identify where they can truly deliver value-added services that will command a market premium. By taking a customer segment approach, as opposed to a product approach, banks can identify and understand individual segments, life stages, specific life events and needs that drive opportunities to provide a richer array of value-added services.

Those services should lend themselves to additional fees, as well as opportunities for bundling products and services that truly meet customer needs (as opposed to the banks' cross-selling services that potentially don't).

Consider, for example, the opportunity to bring retail customers a suite of "home buying" services rather than just a mortgage. What other products and services would be relevant to those customers, such as insurance or home improvement loans? How could the bank position those services in a way that would make them timely and relevant? How could they leverage third-party services in that process?

Similarly, consider the needs of mass-affluent customers with respect to retirement planning. What service model would be appropriate for those customers? How might technology be used to provide those services at an appropriate price point — for example, leveraging videoconferencing for customer interviews — potentially a better customer experience **and** more efficient for the bank?

What are the equivalent scenarios for small business and corporate clients? How can those solutions improve the bank's share of wallet with those customers?

Growth in fee income and the overall contribution of fee income compared to net interest margin will be an important determinant of future profitability. Banks need to be laser-focused on that goal, while also simplifying their commodity offerings.

Moving forward

Having survived the challenges of recent years, banks can return to profitability if they can now effectively leverage the breadth and depth of their customer relationships in a manner that drives true economies of scale. That will require finally tackling underlying complexity to offer a better customer experience while driving a simplified operating model.

During recent years, shareholders have had to absorb the significant costs associated with new regulations, restructuring, asset disposals, litigation and fines. Today, there is an understandable desire to see greater short-term returns. Further investment will be required to enable the banks to move to a structurally lower-cost base with increased productivity, which will enable sustainable long-term profitability. That may be a bitter pill for investors to swallow, but a necessary one. Which banks will be brave enough to come forward with those plans, accepting that there is only so far that traditional cost cutting can take them?

Simply waiting for interest rates to rise is not a strategy. Generating acceptable returns on equity — and reversing the disturbing imbalance between book value and share price — demands focused and decisive action, and the sooner the better.

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Jose Molina, a principal in Grant Thornton's Financial Services Advisory practice

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