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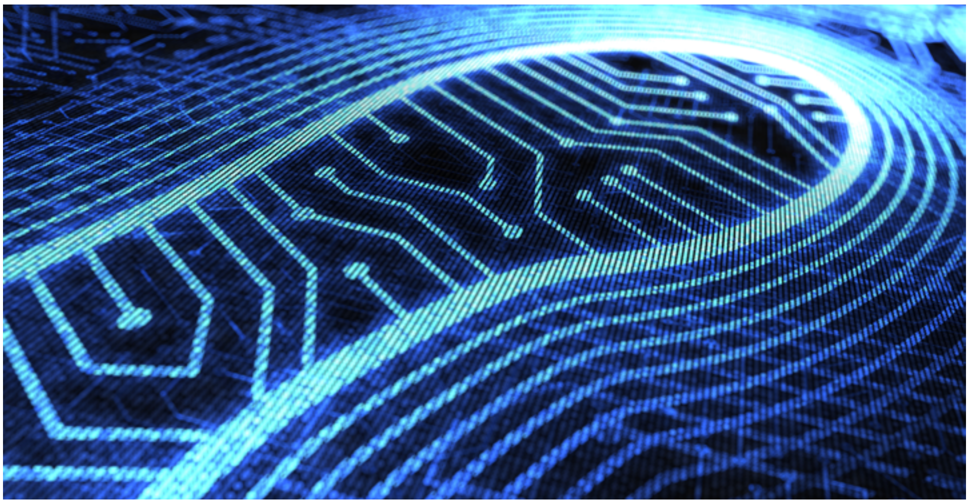
Adopt a light digital footprint over a physical footprint to compete

By
Anna LUMBROSO



During the first conflict in the Middle East, the American Army invented the "Light Footprint" concept, which can be summarised in 3 points. First, do not commit if there is no critical need for it; second, make your team agile and flexible enough to make key decisions quickly; and third, if you can't win, make sure it's a tie and protect yourself from threats. Further developed and enriched in the professional services industry to describe the dynamics, techniques and tools within organisations, there are a number of opportunities to apply this concept to the financial services industry.

There are strong links between the military's physical footprint and the banking world's light digital footprint

Digital friendly countries with limited constraints on data collection and use provide an advantage for banks that could prove valuable to exploit. Let's take the Coverage Cost of a major CIB player as an example: based on our figures, the Coverage cost is around 10% out of the total CIB Costs. While replacing part of the human presence by digital platforms, the positive cost impact could be at least 1%, which, in the scale of a large CIB entity, is far from negligible.

A digital footprint has been named as "the world's most valuable resource" by the Economist because of its impact on customer experience and the way companies communicate. A "light digital footprint" approach could be leveraged in the digital world, oriented towards data collection, smart analytics and an enhanced digital presence. One of our key contacts in a major CIB provided the example from the pharmaceuticals industry: to estimate the demand of the paracetamol market, you could either set up a team that would physically meet pharmacists across a region and gather top-down data; or use a digital platform such as Doctolib.com, an online medical booking platform, to study the requests for medical appointments with general practitioners. Not only would this save time, but the execution cost would be dramatically lower.

This tells us that, within certain business segments, virtual coverage in digitally friendly territories could be heavily driven by digital platforms and assets with a reduced weight of human interactions, resulting in reduced costs and improvement of customer service quality.

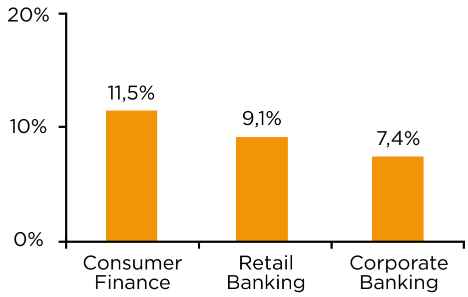
In Private Banking, the hot topic of Impact Investing has been featured on the World Economic forum agenda for a number of years. It has more weighting within the investment portfolio of new generation high-net worth clients and could be largely embraced by specialised platforms with minimum human coverage.

Although it is challenging to change the digital friendliness of certain regions from a regulatory and internet censorship perspective, these examples demonstrate that increasing digital coverage proves to have impact on both cost and revenue in the right segment and geographical regions.

CIB inroads in Consumer Finance are proving difficult

By
Christophe ALBERTO

Goldman Sachs' recent announcement to restrain the rapid expansion of its online lending platform in October led market experts to wonder about the relevance of the bank's last venture into consumer finance, illustrating the challenges CIB players may face while entering adjacent markets without pulling the right levers.



Consumer finance remains a very attractive area for financial players, with a high rate of shareholder returns from 2012-17 (see Figure 1). Western European banks generated c. €60 billion of consumer-finance revenues (after risk costs) in 2017, equal to 18 percent of retail-lending revenues, compared with just €41 billion in 2012. This segment has outperformed almost all other Western European financial services segments and can be explained by consumer finance volume increase in line with GDP growth, improvement of net interest margins on loan books and a reduction in loan loss impairment (c.5% at Marcus).

We have identified 3 success factors for CIB players considering a consumer finance expansion

1. Leverage CIB capabilities

CIB entrants first need to explore and foster relevant synergies with core CIB businesses, meaning that selected interrelationships should positively impact experience curve, capacity usage and/or scale. Typically, CIBs are at the forefront in terms of analytics, risk management, infrastructure and access to capital, and should therefore use those incumbency benefits to create distinctive advantage in consumer finance. To ensure the success of this strategy, CIB entrants need to:

- Select only capabilities that will bring competitive advantage to the new venture
- Manage interfaces strategically (e.g. different set of rules, exchange teams)
- Arbitrate actively (e.g. C-suite level commitment and bias to protect consumer banking within pre-defined boundaries)

2. "Go big or go home"

There is a necessity to build volume in a commodity-based consumer finance environment. With the development of fully digital and low overhead banking services, CIB entrants need to build on this equation to quickly scale up and expand their product offering and markets to build up their customer base, looking at both attractivity (i.e. GDP/capita and digital maturity) and accessibility (i.e. market knowledge and existing local core operations). In this regard, Marcus by Goldman Sachs recently decided to pay its online savings customers 2.25 percent, an increase of 20 basis points versus the former setup. Simultaneously, the rate on its 1-year certificate of deposit rose 10 basis points to 2.75 percent and the firm now intends to replicate this approach in Japan. The intent is to contribute to maximising scale effects, and requires therefore an optimal balance between number of adjacent products and overall complexity.

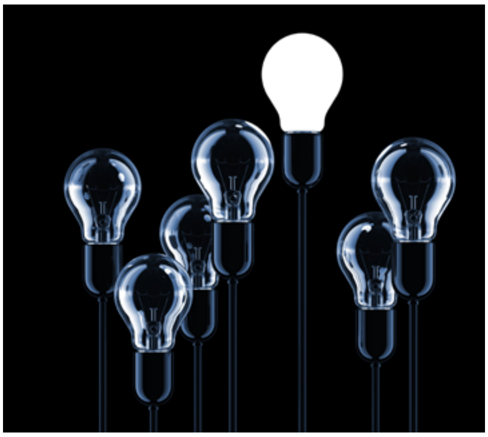
3. Buy customer and technology experience

With their BtoB background, CIB firms could experience difficulties in securing the 'high quality' consumer finance customers and offering the solutions that address their specific needs. Therefore, we believe inorganic growth is the best way to quickly secure talent, technology and a customer base to develop a successful consumer finance franchise. A purchase by a top-tier CIB in April 2018 of Clarity Money, which uses AI to analyse transactions and credit card information is an example of acquisition initiatives designed to target attractive customers and improve their experience.

With the right strategy definition and execution, CIB entrants would not only benefit from attractive consumer finance market returns, they would also increase diversification and bring in additional benefits to their legacy businesses, providing as an example new investment opportunities, such as personal loans, to institutional players.

Smart Supervisory Response is a must

By
Matthew
WESTON



In November 2018, the European Banking Authority (EBA) published the results of its most extensive stress test performed on EU banks since 2009[1]. None of the 48 CIBs tested failed to meet the minimum requirements (capital ratio above 5.5%). However, Italian banks and, more surprisingly, Barclays and Lloyds, were among the worst performers, due to their exposure to riskier credits and bad loans. According to the EBA the **core equity capital ratio of the pool of tested banks fell by 395bps**. Overall the **health of European banks, compared to their US counterparts, remains worrying** due to their credit risk problems previously stated but also lower profitability and cost discipline. As a result, the region's **banking index SX7P declined 20% in 2018**. This was echoed by the ECB's 2019 supervision priorities as its Single Supervisory Mechanism (SSM) defined the following themes as "high-level priority areas for 2019[2]": credit risk; risk management; activities comprising multiple risk dimensions. European CIBs' poor intrinsic health relative to international competitive standards, combined with heightened European regulations that causes increased costs to comply, makes it all the more **vital for them to prepare a new Smart Supervisory Response urbanised and industrial set-up across departments going forward.**

Indeed, **various factors call for short term potential remediation but also a medium-term strategic response to prudential supervision**. A heavy and increasing ECB regulatory agenda has appeared around the Supervisory Review and Evaluation Process (SREP) components (e.g. risk appetite, risk identification, stress tests, capital planning) which induces numerous supervisor investigations within a tight timeframe. For example, a supervisor investigation on market risk components can require an average workload of 2,000 ECB man days which on average necessitates 6,000 man days internally for a bank. Also, the ECB's TRIM (Targeted Review of Internal Models) is designed to assess whether the internal models currently used by banks comply with regulatory requirements and to determine whether they are reliable and comparable (e.g. calculating their Risk Weighted Assets). In addition, recent data regulations potentially steering in opposite directions (e.g. GDPR restraining B2C actors to access data whilst PSD2 allows more access to data for B2B banking) could increase the existing complexity. This intricate set of different regulations can prove treacherous and severe

[1] EU-wide stress testing 2018, 2nd November 2018, eba.europa.eu
[2] ECB Banking Supervision: SSM Supervisory Priorities 2019, 30th October 2018, www.bankingsupervision.europa.eu

penalties could occur if supervisor responses are not prepared accordingly. Finally, banks are encountering an economic value added destruction threat, mainly due to an increase in capital requirements of impacted business lines due to regulatory shortcomings and Opex/Capex overrun to meet regulatory requirements. **Eurogroup Consulting believes that many CIBs are overlooking these potential significant problems and could face a double penalty, as follows:**

Regulatory Charges		Capex Increase		Double penalty
Do not "do the right thing" (e.g regulatory compliance) and face additional regulatory charges / fines	+	Do not "do it right" (e.g efficient supervisor response) and create Capex erosion, e.g. too many man days, to remediate the regulatory responses	=	Eurogroup Consulting estimates, due to net income being adversely impacted by these 2 factors, a bank's Return on Equity could decrease by 25 - 75 bps[3]

We believe CIBs should address this challenge through **3 levers** across SREP items (recurring and non-recurring) and dimensions (e.g. geographies, business and functional lines):

- **Effectiveness** (doing the right things): Positioning the ambition "bar" in terms of regulatory response (e.g. investigating convergence of concepts, optionality in regulatory response). Integration of "forward looking" value creation / risk metrics (revenue / liquidity / risk)
- **Efficiency** (doing things right): Reducing complexity induced by 'fragmentation' across dimensions (e.g. geographies, business lines, IT, data etc) and enforcing "smart governance" with an urbanised and industrial set-up. Containing direct Opex / Capex via legitimate optimisation levers (e.g. non-disruptive and disruptive)
- **Fostering enablers:** Raising full awareness on SREP stakes throughout the CIB organisation (e.g. harsh penalties could be imposed). Empower people to remediate in an agile fashion (i.e. new ways of working, "auto-repair") and plan for tomorrow (i.e. big and integrated forward-looking picture). Create the right set-up to manage their relationship with regulators regarding their compliance challenges.

Therefore an innovative Smart Supervisory Response, via the creation of a dedicated urbanised and industrial set-up and team with suitable talent across functions, **is a must for European CIBs to avoid short term supervisory shocks whilst being able to strategically navigate regulations in the mid and long terms**. A few CIBs, mainly non-European, have embraced this dedicated urbanised supervisory response and this has been **proven successful so far**.

[3] Dependent on the level of regulatory charges / fines imposed by the supervisor

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Anna is a graduate from Sciences Po Paris and has started her career reporting to the Board of CAC40 companies and covering growth, operational strategy and transformation projects. She has extensive experience in Financial Services working for multiple consulting firms, supporting leading European and global banks and insurance companies. She joined Eurogroup Consulting to focus on CIB / Wealth Management and support clients with their strategy, operations and compliance issues.

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Matthew is an experienced financial services practitioner, focusing on corporate and investment banking, and has a proven track record of high-quality delivery. He has developed an expertise in a few core areas, primarily product control improvement (broad risk and finance interaction), change management, large corporate coverage optimisation and compliance department reorganisation. Matthew holds an MBA from the University of Cambridge.

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