Banking

Ana Lacerda

Fall Semester 2024

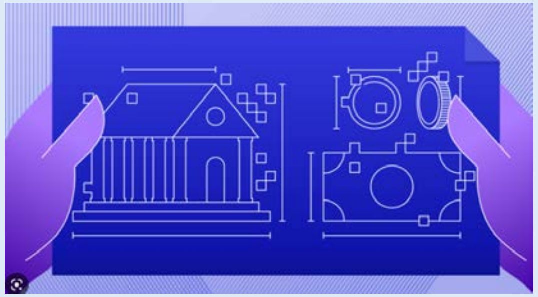
Course: Banking [2206]

Strategy

Disclaimer: The views expressed are my own and do not necessarily represent the views of Banco de Portugal.

To be covered today

- Strategy:
- How different strategies shape the landscape
- A product *vs* a client-oriented bank [not covered]
- The value of a client!
- Porter's competitive forces [not covered]
- The "new" business model [not covered]
- A view from the industry perspective



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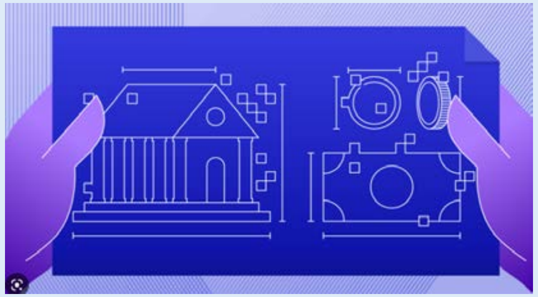


Important categories of institutions

We can think about four main categories of financial institutions:

Central Banks
Oversee and manage all banks in their respective country and set monetary policy

Retail Banks
Provide products and services to individual consumers

Commercial Banks
Work with businesses to serve their financial needs

Investment Banks
Operate in the capital markets to help clients raise capital through underwriting and issuance of securities

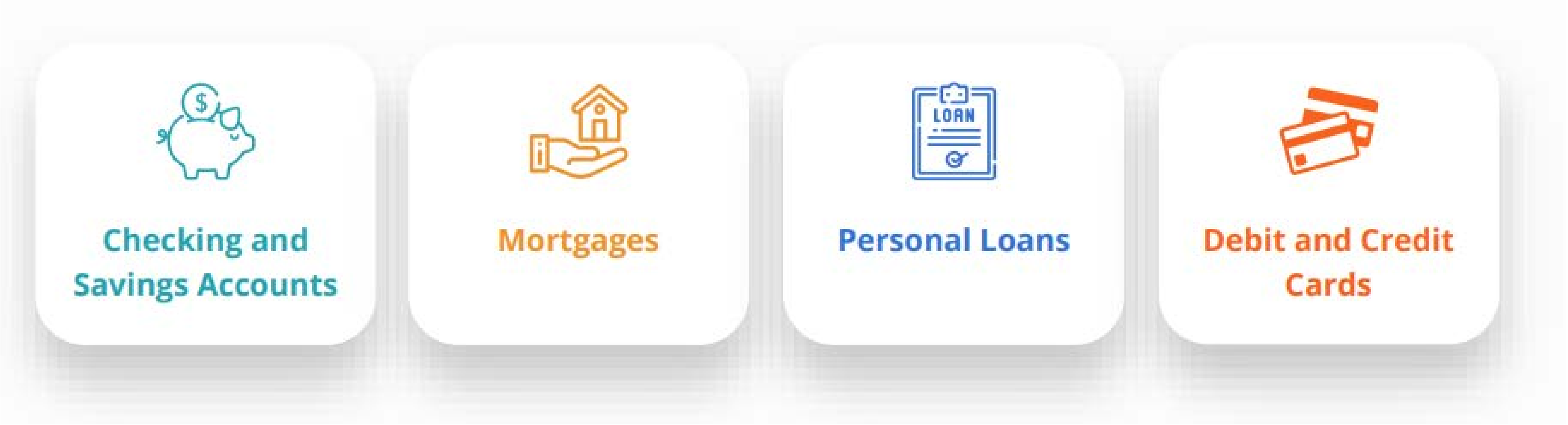
Source: CFI

Banking Services

Banking Services: Retail banking

Retail banking is the provision of banking services to all individual consumers.

Examples of retail services



Banking Services: Private banking

Private banking is a subset (!) of retail banking that caters to high-net-worth and ultra-high-net-worth individuals.

Customer service is provided on a personal basis through a dedicated relationship manager. Services include retail banking products, asset management, brokerage, and limited tax advisory.

Banking Services: Business Banking

Business banking refers to banking services provided to small businesses that are owner-operated and have annual revenues of up to $5 million (*according to CFI definition*).

These businesses have very simple banking needs:

What are the likely reasons for financial support to small businesses from the bank?

Banking Services: Commercial Banking

Commercial banking is larger in scale than business banking and serves clients with more complex needs.

The needs of commercial banking clients are focused around:

Clients are typically:

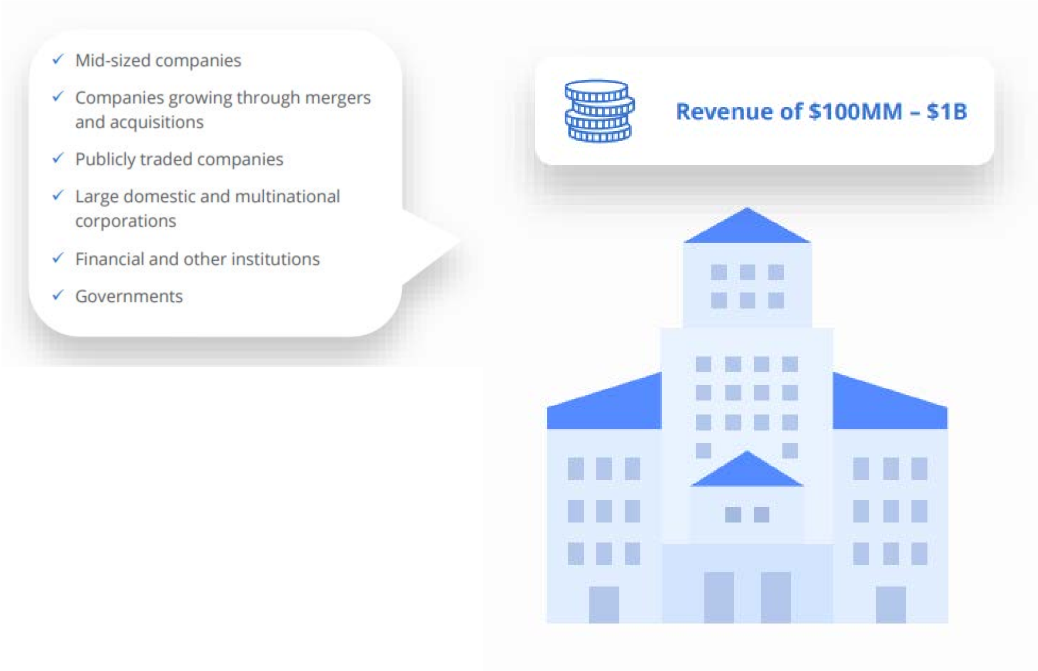
1. Medium-sized (~500 employees)
2. Multiple locations and possibly various geographic locations
3. May include other financial institutions and local / regional governments

- Operating Accounts and Loan Finance Products
- Transaction Banking (Cash and Treasury Management)
- Trade Finance and Foreign Exchange
- Advisory Services

Banking Services: Corporate Banking

Corporate banking services are for those clients whose needs are even more complex than in commercial banking.

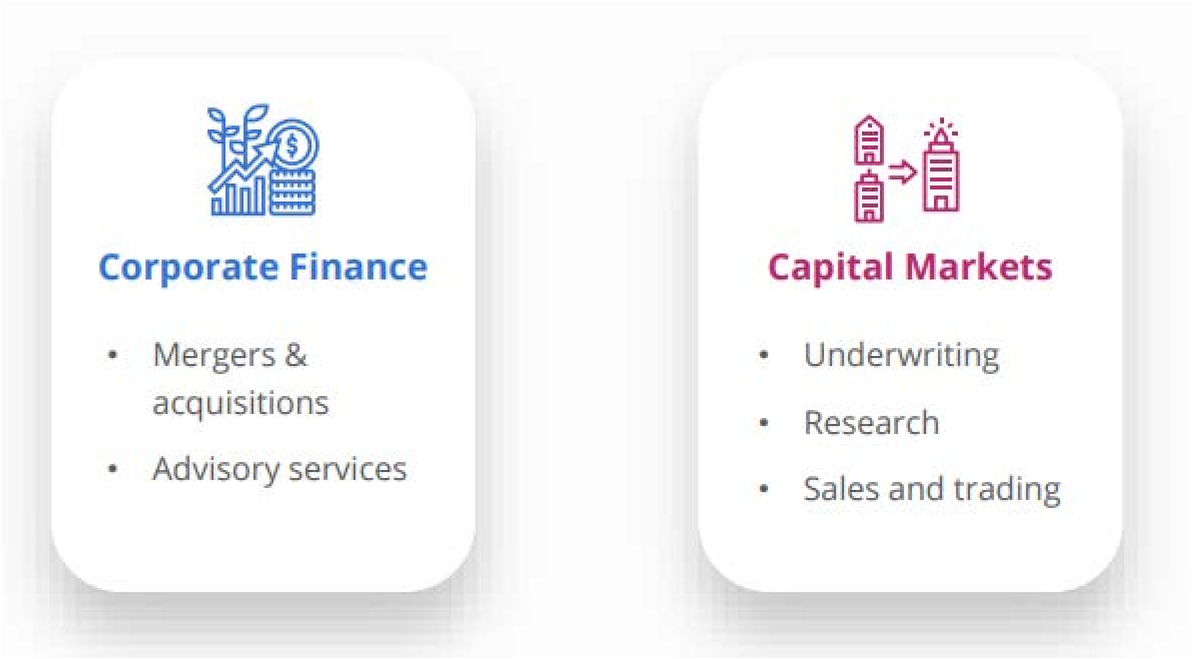
Corporate banking services are largely credit-related with an advisory component and act in between commercial banking and investment banking services.



Banking Services: Investment Banking

Investment banks do not offer traditional banking products and are non-deposit taking.

They serve large, publicly traded corporations, institutions, and governments looking for banking services associated with large or complex financial transactions in:



Banking Services: Investment Banking

Corporate Banking

- Act as an intermediary
- Maintain banking relationship with clients

vs.

Investment Banking

- Directly offers advisory services for M&A transactions and structuring of capital markets products
- Assisting organizations to raise capital through equity or debt
- E.g. Initial public offering (IPO)

How financial institutions are organized

1. Universal Banks

2. Large Banks

3. Investment Banks

4. Community Banks

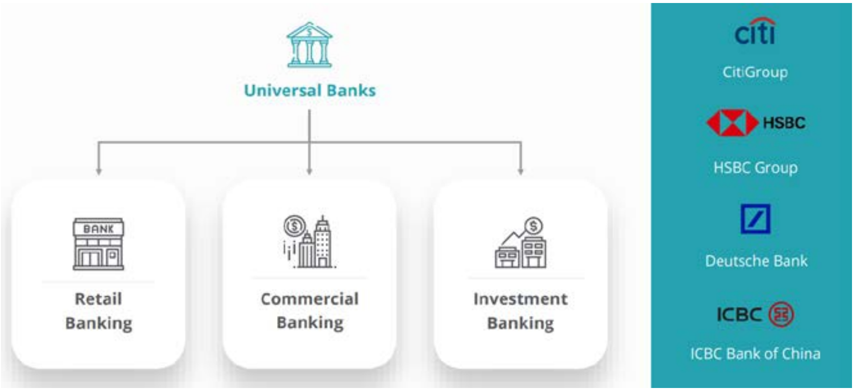
5. Online Banks

6. Credit Unions

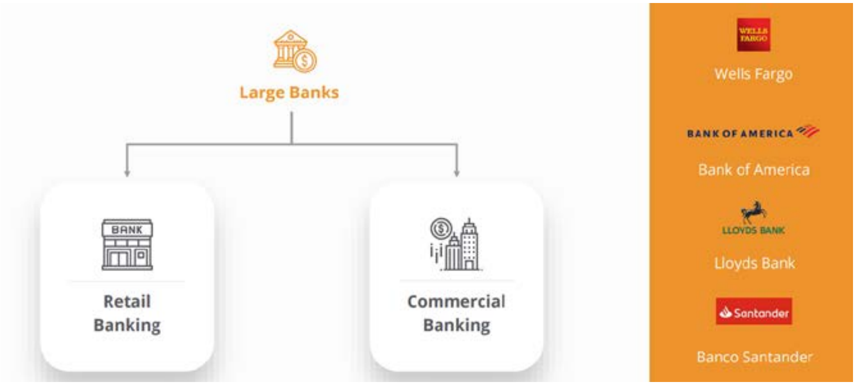
7. Building Societies

8. Savings & Loans Associations

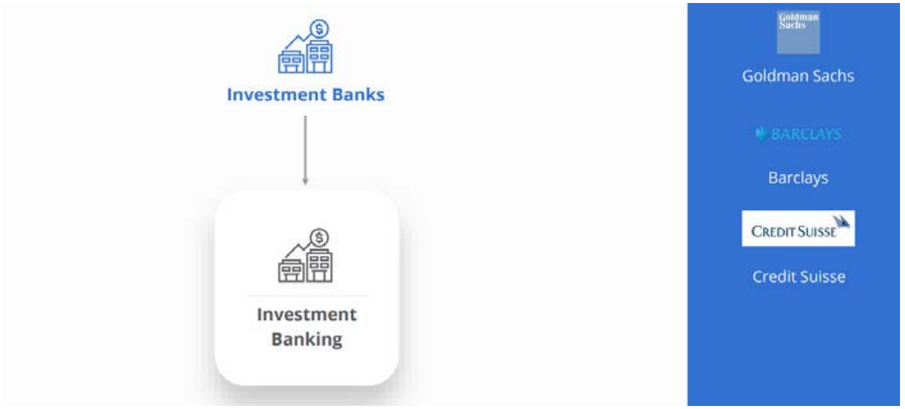
1. Universal Banks



2. Large banks

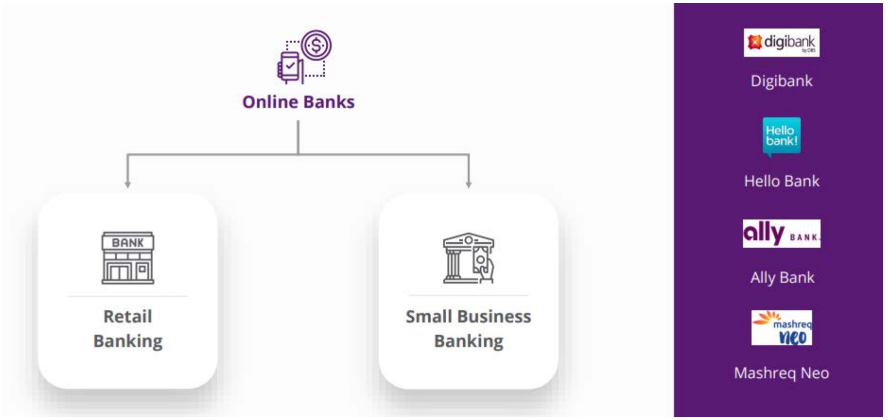


3. Investment banks

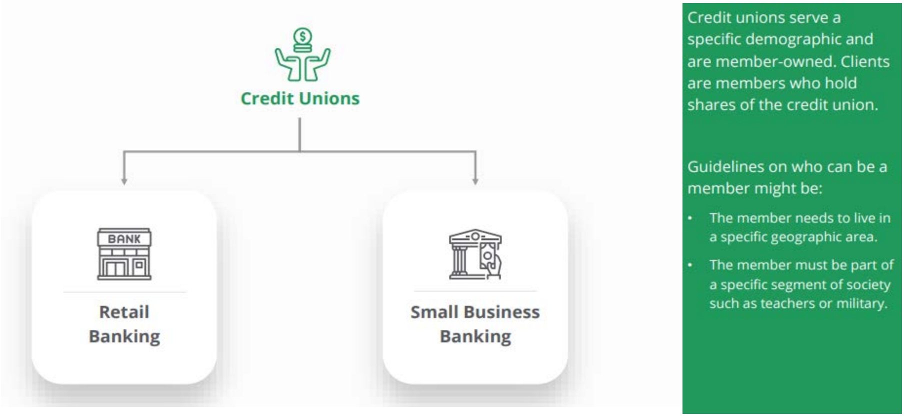


4. Community banks

5. Online/digital banks



6. Credit Unions



7. Building Societies

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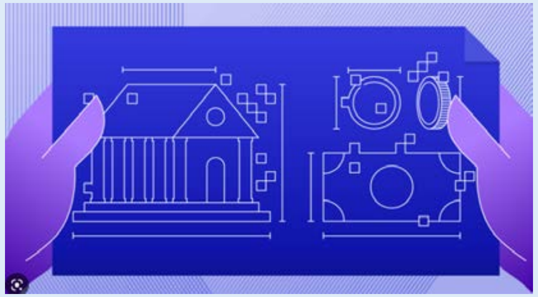
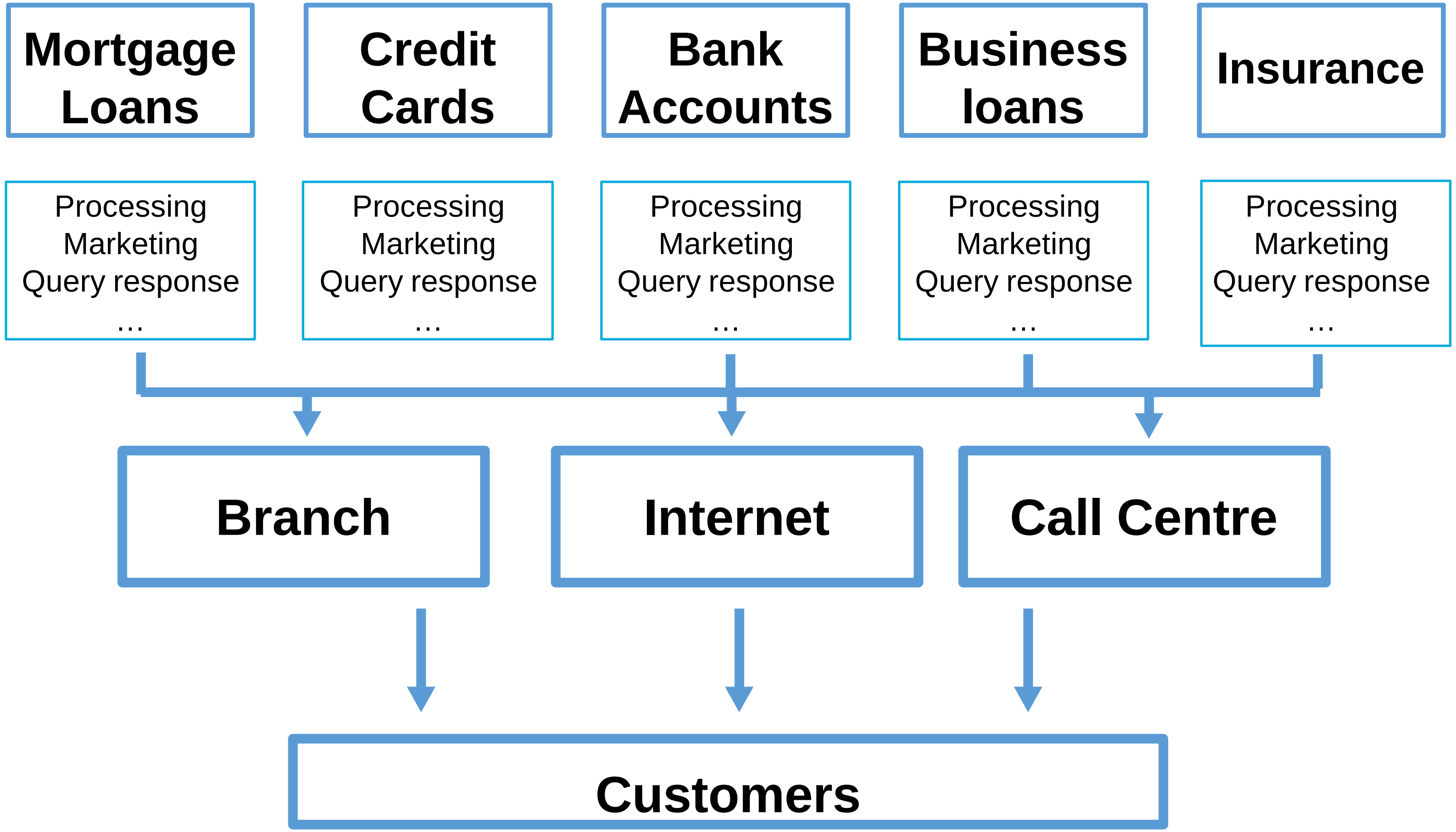
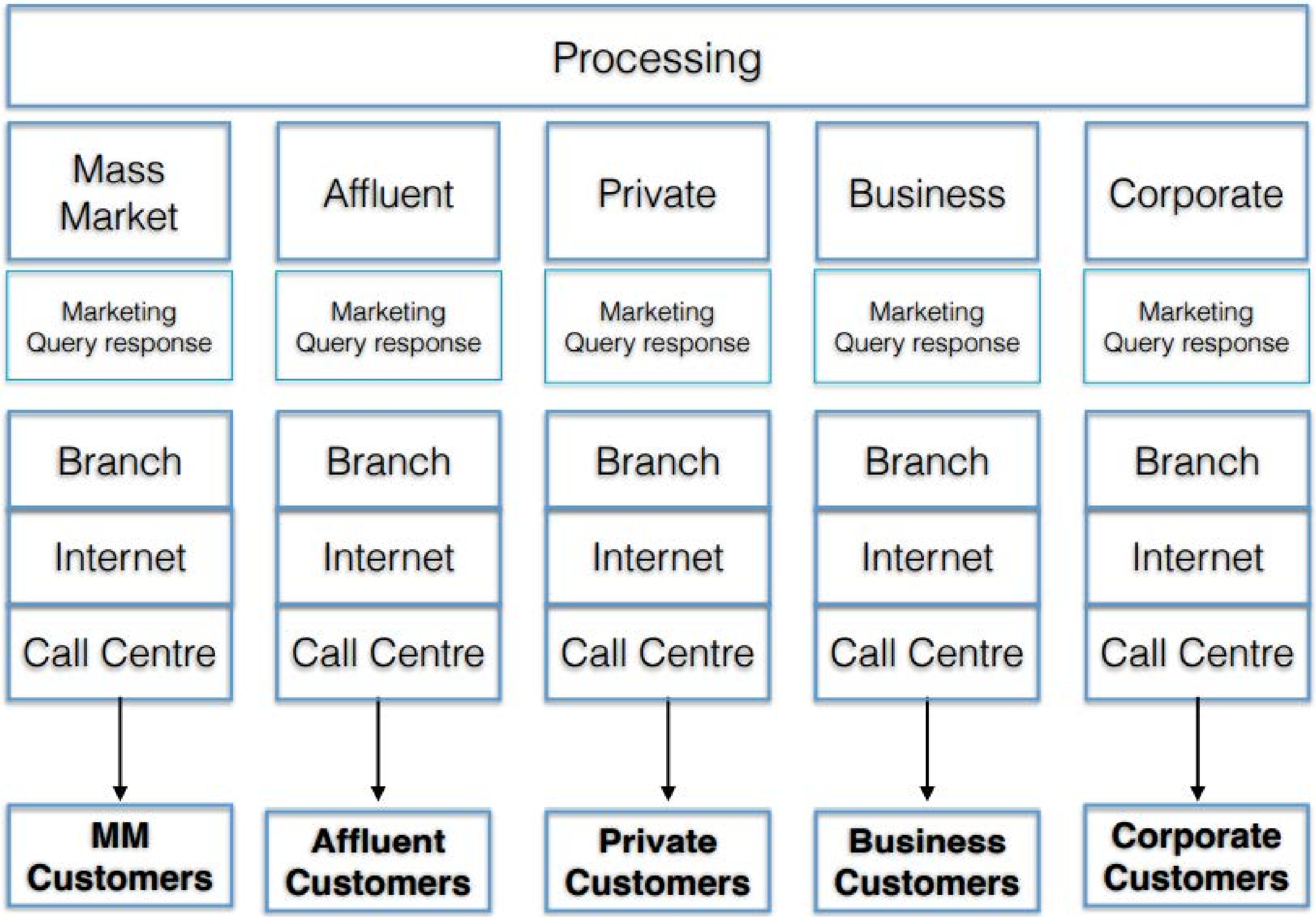


A product oriented bank



A client oriented bank



Deal with segmentation

How to segment customers

- traditional (individuals, companies)
- by asset or sales volume (mass, affluent, private, business, corporates)
- by behaviour (large savers, small savers, large debtors, small debtors, high transaction, low transaction)
- by life cycle (student, young professional, family professional, retired, startup, growth business, mature business)

The choice will affect how the bank will address customer demand.

Deal with multiple channels

- Branch - transactional? Just for individuals? no cash operations? advisory? to whom?
- ATM - info, cash operations, transactions, inbound sales?, outbound sales?
- Internet
  - informational and transactional
  - very limited in-bound sales; can you really do out-bound?
- Call centre
  - inbound - transactional, informational, claims
  - outbound – CRM (Customer relationship management)
- Mobile - used to be a phone… but a tablet is again internet
- POS - can this be a bank channel?
- Mail - are we forgetting the good old paper, or just forget that?

P&L of a customer

interest paid on savings accounts	investment income from deposit balances
transactions related costs	fee income
impairments	loan interests
allocated “fixed” costs	

Let’s value the client

- Mr Client has 700 euros in deposits, earning 2%.
- He pays 10 euros/month of fees and commissions
- He has a loan of 8000 euros, paying 5% interest rate.
- According to the credit analysis of the bank, Mr. Client has a 2.5% probability of default, in which case the bank may lose 60% of the loan amount.
- The bank faces 85 euros annually of operating costs to deal with Mr. Client business
- The law forces the bank to have 3% of cash reserves (over deposits) and 8% equity over assets.
- The Treasury department of the bank quotes liquidity at bid/ask of 3,25% - 3,75%.
- Capital at the bank costs 7.7%.

Build the balance sheet and the Profit & Loss statement of this client.

Balance Sheet with Mr. Client

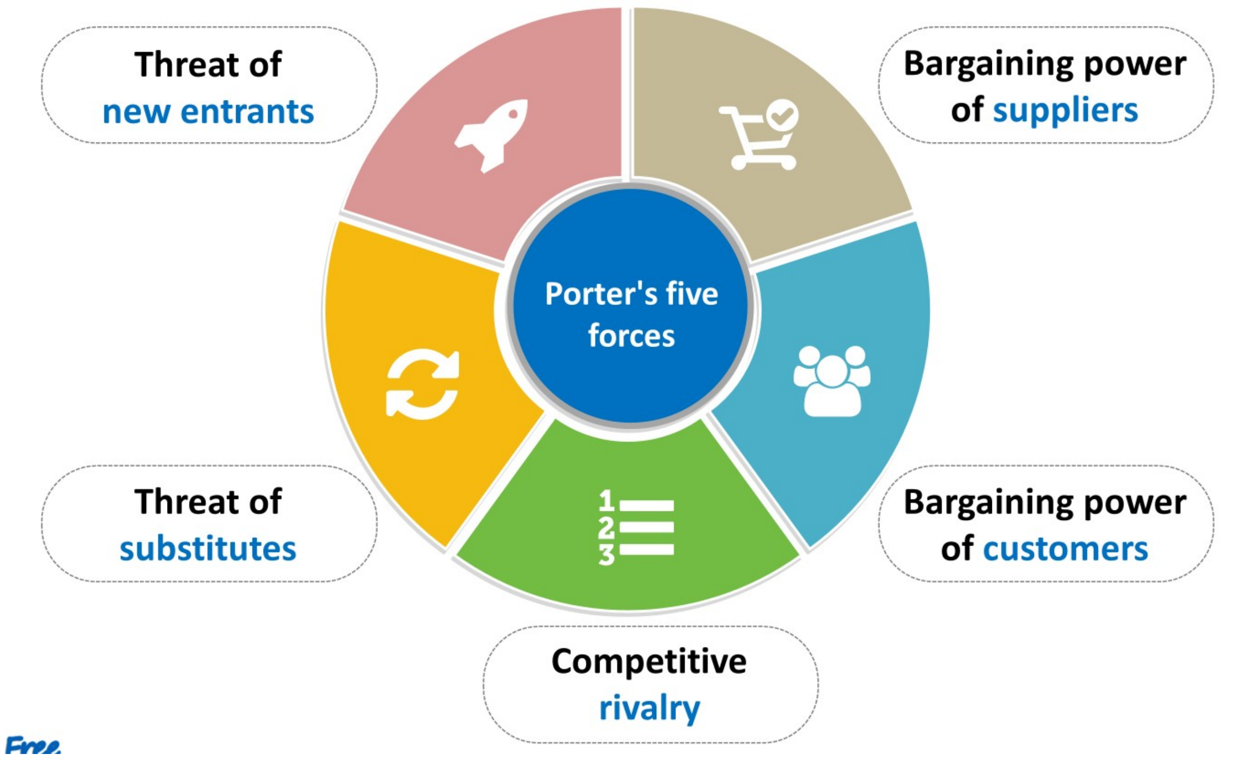
Assets		
Cash Reserves	21	The bank needs to retain 3% of the deposit as cash reserves.
Pool Funds	679	All deposit not needed as reserves can be sold to the pool.
Loan	8000	
Total assets	8700	
Liabilities		
Deposits	700	
Pool Funds	7360	We used 92% of the loan from the pool. So we have 8000 x 92%.
Capital	640	We used 8% of the loan from capital. So we have 8000 x 8%.
Total liabilities	8700	

Mr. Client P&L

Income		
Interest on the loan	394	The bank expects to lose 1,5% of interests (2,5% x 60%), and also of capital. So, we have 8000 x 5% x 98,5%.
Fees	120	
Selling liquidity to pool	22	We have 700 x (1 - 3%) x 3,25%
Total income	536	
Cost		
Interest on deposit	14	
Expected Loss	120	The bank expects to lose 1,5% of capital lent (2,5% x 60%).. So, we have 8000 x 1,5%.
Operating costs	85	
Cost of liquidity	276	We used 92% of the loan from the pool. So we have 8000 x 92% x 3,75%.
Cost of capital	49	We have here 8% x 8000 * 7,7%
Total cost	544	

Economic Value Added of Mr. Client is negative (-8)

Porter's competitive forces



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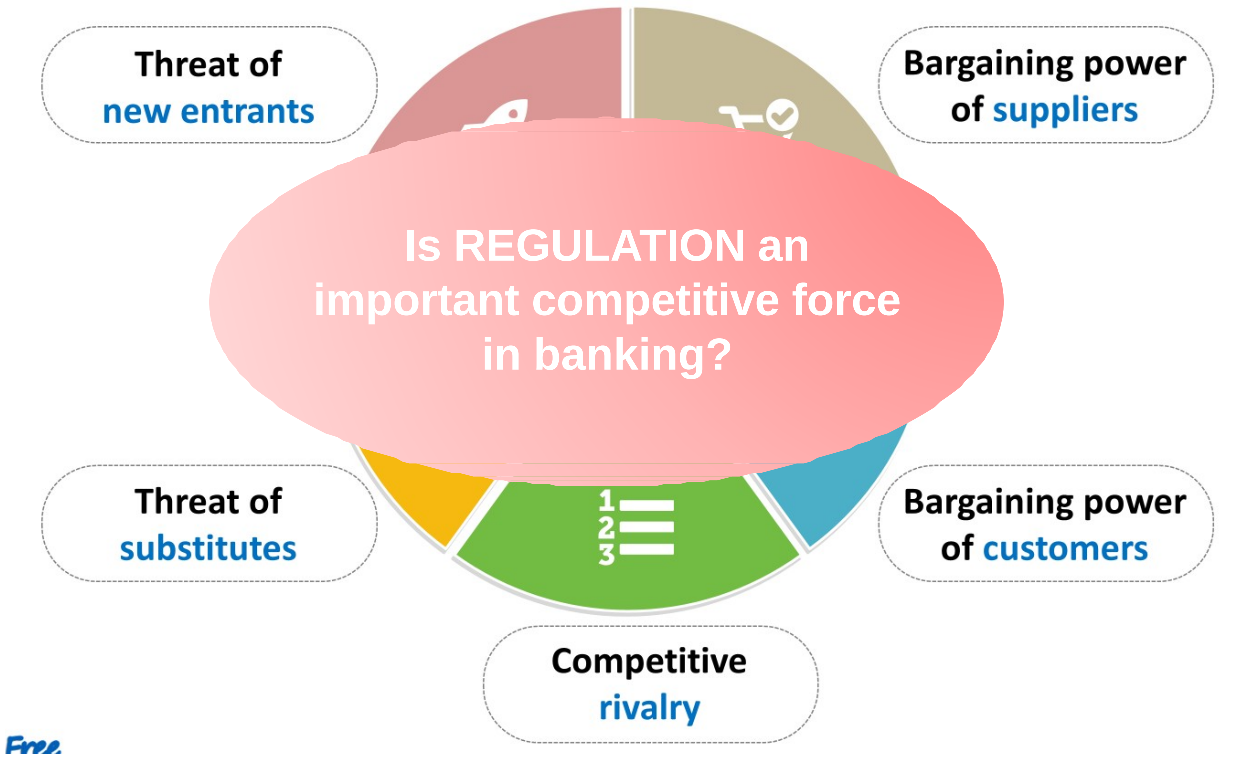


Capital

Regulatory capital - capital items accepted by regulation, and can be fulfilled by core capital (equity, retained earnings) or supplementary capital (revaluation reserves, junior bonds). Sometimes used to refer the minimum capital a bank must have.

Book value capital - is the historic accounting difference between assets and liabilities (so junior bonds are not capital)

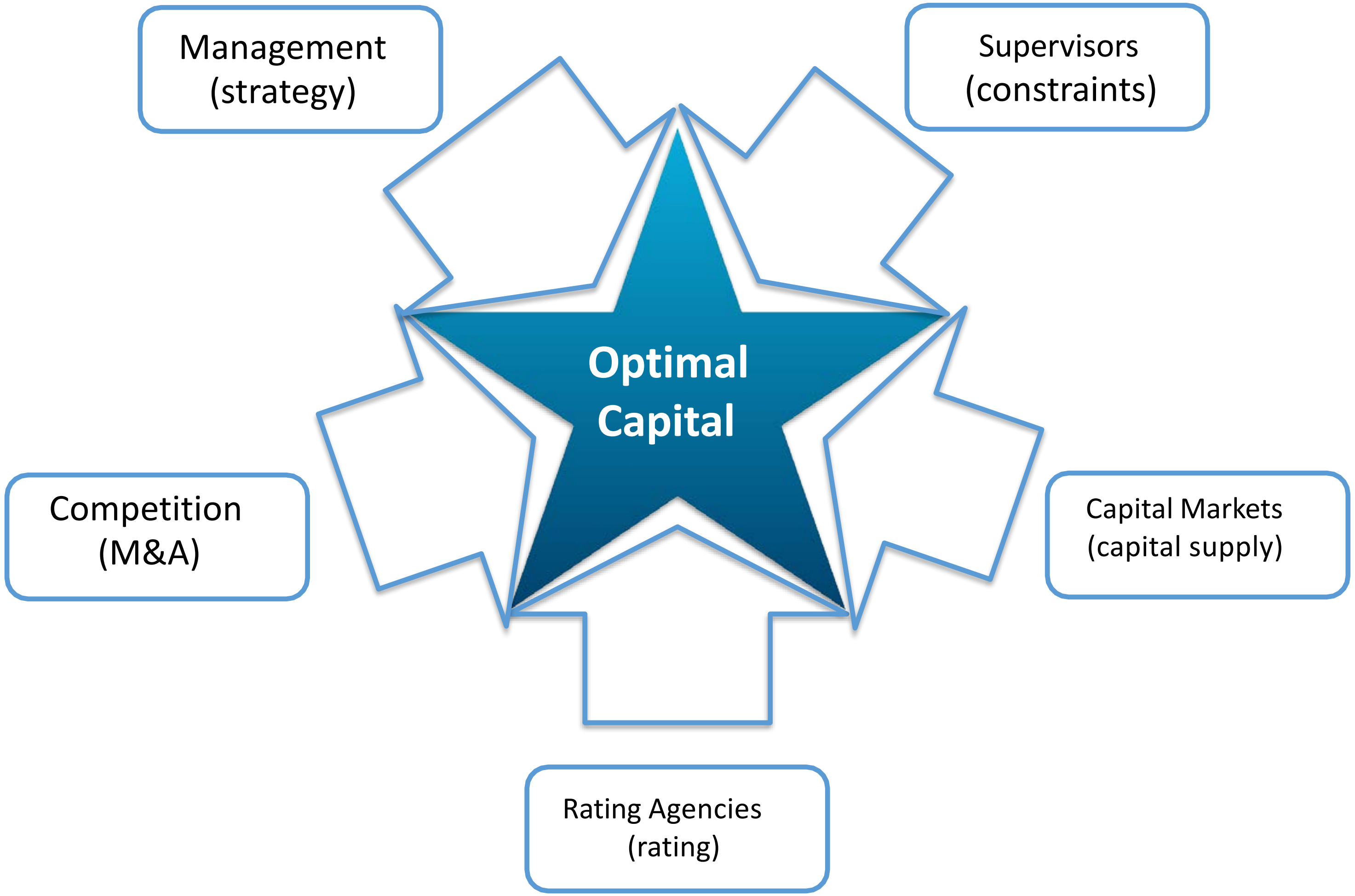
Fair value capital - is the fair value (present value of future cash flows) difference between assets and liabilities

Market capitalization - number of outstanding shares times market price of the shares (in a way, it is the perceived fair value capital)

Economic capital - amount of capital needed to cover risks (CaR)

Available capital - is the amount of equity (or similar instruments) existent in the bank that can absorb losses (meaning without the bank declaring bankruptcy), or equity, retained earnings, contingent convertibles

Factors affecting available capital



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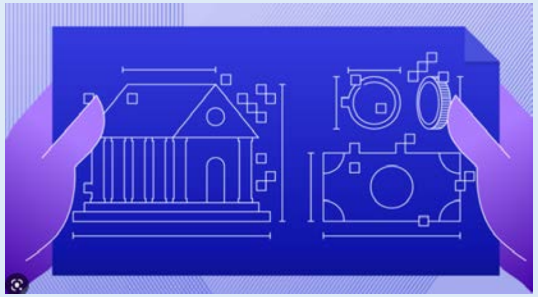
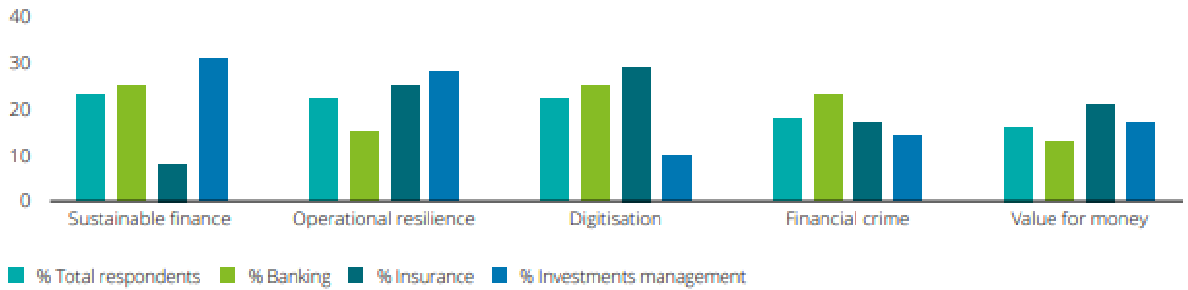


A view from the industry on banking strategy

A view from the industry

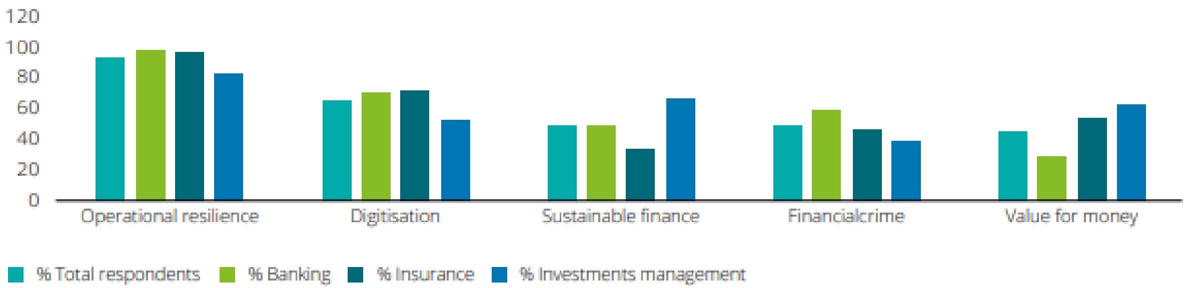
To inform this report, we conducted a survey of 93 senior executives and non-executives at financial services firms.[ii] We asked them to rank the top three regulatory topics (out of a list of five) that they expected the Board and ExCo to spend the most time on in 2022. Sustainable finance came out as the top priority (selected by 23% of respondents), narrowly ahead of operational resilience and digitisation (both selected by 22% of respondents). But there were sectoral differences, with insurers putting the other two regulatory topics ahead of sustainable finance. In terms of the topics which featured as a top three priority, operational resilience was the clear winner (selected by 92% of respondents).

Chart 7. Which regulatory topic do you expect to require most Board/ExCo attention in 2022? (ranked as a top priority)



Source: Deloitte EMEA Centre for Regulatory Strategy Regulatory Outlook 2022 Survey, October 2021

Chart 8. Which regulatory topic do you expect to require most Board/ExCo attention in 2022? (ranked as a top three priority)



Source: Deloitte EMEA Centre for Regulatory Strategy Regulatory Outlook 2022 Survey, October 2021

1. Transition to a sustainable economy

Turning pledges into plans

Actions for firms

Credible net zero plans and leveraging opportunities

- Develop a Board-reviewed transition strategy and aligned roadmap and a detailed and resourced plan of actions, which includes interim targets.
- Measure emissions across the value chain, focusing on financed emissions, and develop a decarbonisation pathway using science-based targets.
- Integrate net zero considerations into investment, lending and/or underwriting decisions, while giving careful consideration to stakeholder engagement.
- Develop products and solutions which meet regulatory expectations and market demand.
- Cascade net zero plans across the firm, leverage risk management framework and ensure coordination between corporate strategy, business units and control functions.
- Ensure remuneration, incentives and culture are aligned with net zero plans.

Non-financial risk management

- Ensure reputational, liability and conduct risks stemming from climate and environment factors are identified and integrated into risk management frameworks.
- Ensure that Compliance and other key control functions receive training (e.g. on ESG data, non-financial performance metrics, or ESG investment strategies) so that they can assess green product disclosures.

Disclosures and data

- Develop a robust ESG data strategy and target operating model to ensure quality and consistency across data for ESG risk, net zero commitments, taxonomy-alignment, and disclosures.
- Consider regulators' concerns when using ESG ratings and data providers e.g. conduct due diligence of vendors and avoid mechanistic reliance on ESG ratings and data products.

2. Climate-related risk management

"A checkpoint, not a full stop"

Actions for firms

Operating model

- Develop a future state operating model view for risk management capabilities, specifying a plan to implement it that builds in flexibility to accommodate evolving mitigation, adaptation or transitional expectations. Assess plan and current capabilities against benchmarks of good practice as they are made available.

Business performance management

- Climate risk considerations are permeating the regulatory capital architecture. Firms should form an initial view, for example, of how the "greenness" of their balance sheet affects cost of capital or return on capital, and consider how that might influence future balance sheet strategy.

Scenario analysis and capital modelling

- Develop scenario analysis/stress testing capabilities. Approach should be proportionate to the size and complexity of the business, but should engage the Board and all relevant functions.
- Apply scenario analysis to inform climate risk assessment in ICAAP/ ORSA.

Nature risk

- Undertake an initial assessment to understand nature risk on the balance sheet. Asses the priorities of supervisors, and where these new risk considerations could usefully be incorporated into existing plans.

3. Innovation

Fitting square pegs into round holes

Action

> "Since around 95% of the US$2.6 trillion crypto market is unbacked, the bulk of these assets are vulnerable to major price corrections. This raises significant issues related to investor protection and market integrity."
>
> **Carolyn Wilkins,** *external member of the FPC*[15]

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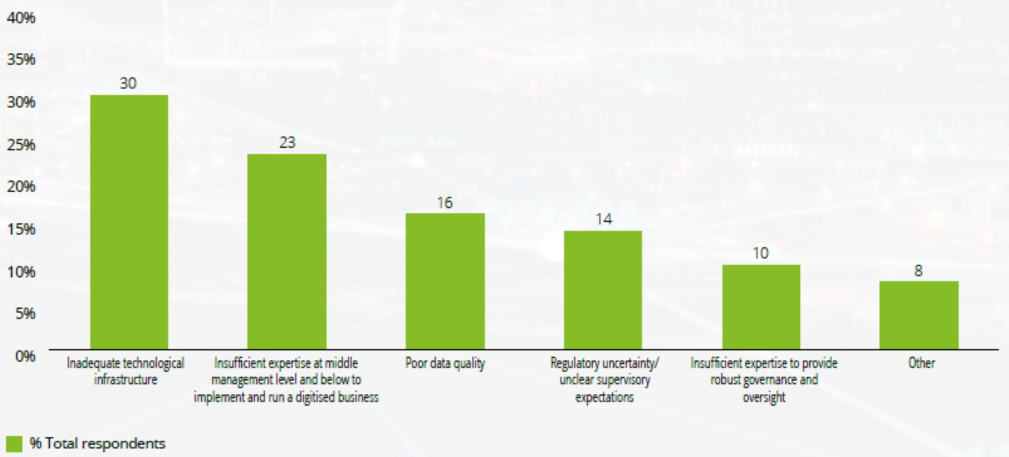
those arising from regulated/unregulated TPPs.

> "…the [BNPL] option will make up more than half of the embedded finance market by 2026."
>
> *Sifted/Reports Embedded Finance*[16]

- Build capabilities, such as data/Open Banking and reporting systems, to prepare for new BNPL regulatory requirements.

Chart 9. What is the most important challenge that your firm will face in digitalising your business over the next year?



Source: Deloitte EMEA Centre for Regulatory Strategy Regulatory Outlook 2022 Survey, October 2021

3. Innovation

Fitting square pegs into round holes

Actions for firms

Cryptoassets

- Boards should ensure risk appetite, governance, and risk management frameworks address new/enhanced risks (e.g. financial and fraud) arising from cryptoassets – especially if unregulated - and derivatives based on them.
- Incumbents should consider impact of cryptoassets' growth on traditional revenue sources, and potential responses.
- Crypto natives should prioritise robust governance and risk controls to support successful regulatory authorisations.

Embedded finance, including BNPL

- Monitor evolving regulatory/supervisory expectations if working with/ relying on digital platforms or BNPL firms.
- Build capabilities, such as data/Open Banking and reporting systems, to prepare for new BNPL regulatory requirements.
- If relying on a platform-based business model, consider reputational and operational risks, and how to ensure good customer outcomes and regulatory compliance.

Digital payments

- Be ready to explain business models, risk and mitigants in detail, including spill-over risks from unregulated activities.
- Demonstrate skills, resources and capabilities to maintain financial and operational resilience, and consumer protection, including through periods of fast growth.
- Identify and address vulnerabilities in operating models, including those arising from regulated/unregulated TPPs.

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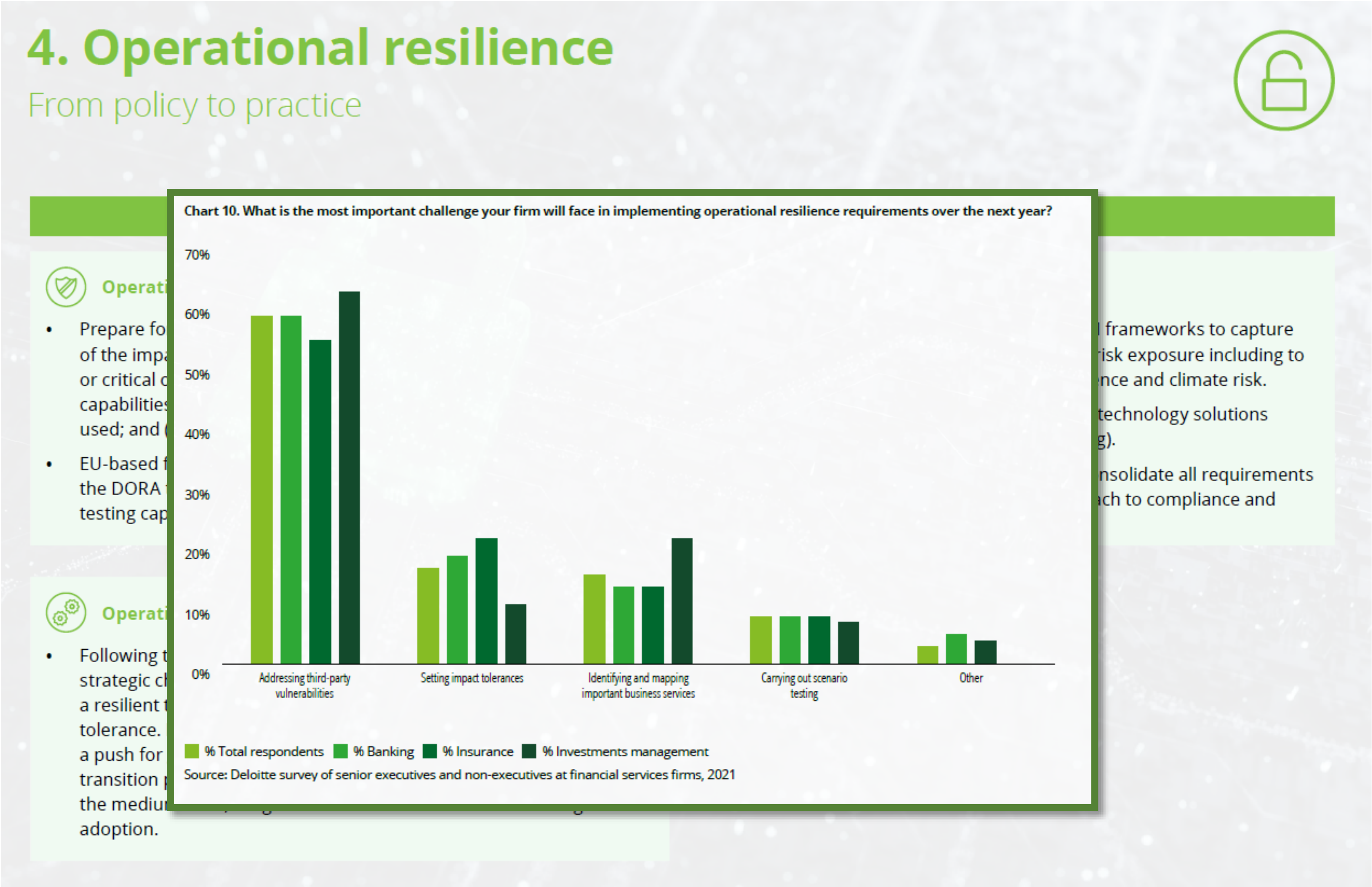


4. Operational resilience
From policy to practice
Chart 10. What is the most important challenge your firm will face in implementing operational resilience requirements over the next year?
70%
60%
50%
40%
30%
20%
10%
0%
Addressing third-party vulnerabilities
Setting impact tolerances
Identifying and mapping important business services
Carrying out scenario testing
Other
% Total respondents
% Banking
% Insurance
% Investments management
Source: Deloitte survey of senior executives and non-executives at financial services firms, 2021

4. Operational resilience

From policy to practice

Actions for firms

Operational resilience

- Prepare for heightened supervisory scrutiny of: (1) the sufficiency of the impact tolerances set or risk appetites articulated for IBSs or critical operations; (2) the sophistication of scenario testing capabilities and the severity of the operational disruption scenarios used; and (3) the resilience implications of TPP relationships.
- EU-based firms: conduct gap analyses based on the final version of the DORA to assess where their ICT risk management, reporting or testing capabilities need improvement.

Third-party risk management

- Update traditional segmentation and TPRM frameworks to capture all TPP relationships, their materiality, and risk exposure including to new risk domains, e.g. TPPs' financial resilience and climate risk.
- Enhance TPRM systems, including through technology solutions (e.g. real-time risk intelligence and reporting).
- If in-scope of multiple outsourcing rules, consolidate all requirements and, where practicable, standardise approach to compliance and thereby increase efficiency.

Operating model design

- Following the March 2022 deadline, UK firms will need to make strategic choices around investment in infrastructure and embedding a resilient target operating model to operate within their impact tolerance. Boards and senior management should consider whether a push for greater operational resilience will hinder their digital transition plans and challenge themselves to identify how, over the medium term, a higher level of resilience could enable digital adoption.

5. Revising the capital framework

A year of important decisions

Actions for firms

Basel 3.1 timetable divergence

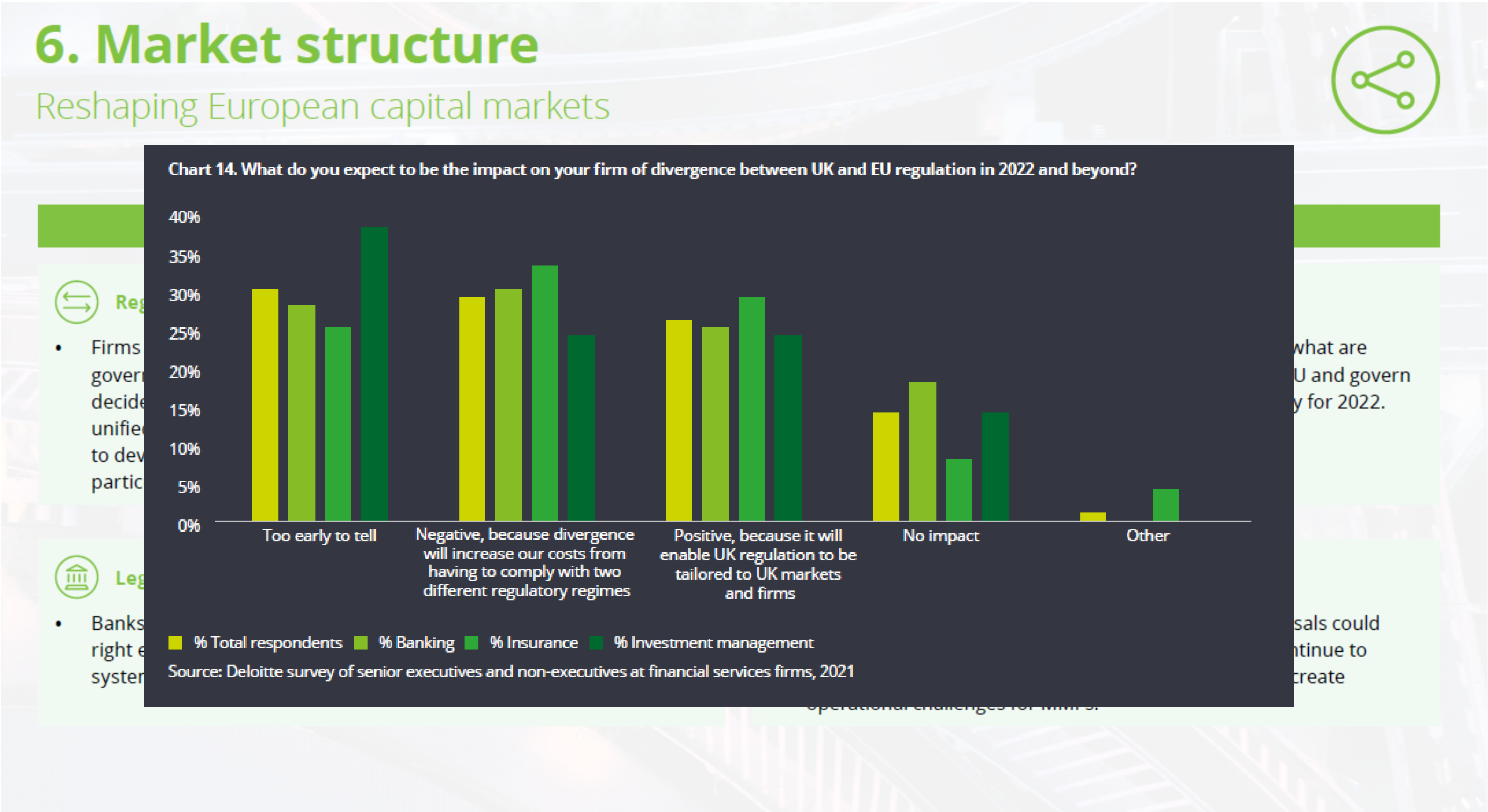
- Banks will need to decide how they reconcile the Basel 3.1 target date for implementation coming at the end of the year with the reality that regulators in many jurisdictions either will not be ready to implement the framework or will not require it. Managing this regulatory divergence in timing could impose extra demands on banks' finance risk and compliance activities.

Solvency II "no-regrets" actions

- Insurers should develop an implementation approach for Solvency II reform (e.g., investing in stress testing and modelling capabilities) and ensure the direction of travel of the reforms is factored into other change programmes (e.g., IFRS 17 or group restructuring or reorganisation), allowing for the fact that resources for these projects may overlap.

Basel 3.1 "no-regrets" actions

- IRB banks should begin to prepare immediately for using the standardised approach for the purpose of calculating the output floor. They should also begin to assess how they will understand the "floor capacity" available in their internal capital allocation once the output floor is in force, and the implications for capital intensity and product pricing.


6. Market structure
Reshaping European capital markets
Chart 14. What do you expect to be the impact on your firm of divergence between UK and EU regulation in 2022 and beyond?
40%
35%
30%
25%
20%
15%
10%
5%
0%
Too early to tell
Negative, because divergence will increase our costs from having to comply with two different regulatory regimes
Positive, because it will enable UK regulation to be tailored to UK markets and firms
No impact
Other
% Total respondents
% Banking
% Insurance
% Investment management
Source: Deloitte survey of senior executives and non-executives at financial services firms, 2021

6. Market structure

Reshaping European capital markets

Actions for firms

Regulatory divergence

- Firms with a presence in both the UK and EU will need to have clear governance and decision-making frameworks to enable them to decide whether it is both possible and cost-effective to have a single, unified approach to regulatory compliance, or whether they need to develop two (or more) different approaches to deal with local particularities.

IPU

- Many banks are likely to find it challenging to integrate what are currently highly siloed individual entities into a single IPU and govern it effectively. Making progress on integration is a priority for 2022.

Legal entity structures

- Banks should optimise their legal entities to ensure they have the right entities, regulatory permissions, risk model approvals and systems to support their clients and achieve sustainable profitability.

MMFs

- MMFs will want to consider how different reform proposals could affect their position in the market and how they can continue to remain attractive to investors. Some reforms may also create operational challenges for MMFs.

8. Financial crime

It's broken….so fix it

Actions for firms

AML/CTF processes

Perform a review to ensure:

- all three lines of defence are appropriately engaged and management responds to findings/recommendations;
- processes are risk-sensitive;
- escalation steps are clear;
- customers' interests are central; and
- processes use both internal and external data.

Understand fraud/scam and market abuse challenges

- Ensure processes to identify and prevent fraud and scams are integrated into risk management frameworks.
- Ensure reporting obligations for identified/suspected cases of fraud and scams are followed.
- Review back and middle office processes to ensure reporting and transparency requirements are rigorously enforced.
- Assess and be ready to implement rapidly technology and process changes needed for upgraded Digital ID frameworks.

Confirmation of payee

- If not yet offering CoP, develop a clear roadmap to CoP implementation by end 2022.
- All PSPs should engage early with the PSR concerning any potential setbacks to CoP adoption, including delays in implementing a CoP-only role profile in the Open Banking Directory.

$994 million

Global fines levied for AML failings in H1 2021.[30]

7. Value for money

A greater focus on pricing levels

Actions for firms

UK firms

- GI manufacturers will need to consider how to automate and standardise the data they receive the data they receive on distribution costs.
- AFM Boards and SMFs will need to evidence that they have robustly challenged the value assessment process for their funds and considered the feedback in the FCA's review.
- UK firms will need to consider how to align their different processes which are related to assessing value (e.g. under product governance, the Consumer Duty, sector-specific value assessments, suitability assessments).

EU firms

- EU firms will need to prepare for more supervisory scrutiny of their pricing levels and be ready to justify how their products deliver value.
- Irish motor and home insurers will need to reassess their pricing strategy in light of the CBI's proposed ban on "price-walking".

9. Governance

Improving decision-making and oversight

Actions for firms

Governance model

- Review the governance model to ensure new risks such as climate are appropriately covered. Consider how the model needs to be altered to ensure risks and issues are reported at the appropriate levels and the Board can focus on key/high priority risks and issues. Some firms are establishing Board committees to focus on specific risks whilst others, wary of proliferation, are considering how they can streamline existing Board committees to deal effectively with new risks.

Management Information

- Review and refresh the end-to-end reporting lifecycle to ensure MI not only focuses on the most relevant risks but adapts to emerging ones. Improving data governance and processes will increase access to better quality, more consistent and granular data, leading to more effective, efficient, near real-time reporting and analytics. A move from retrospective MI to predictive MI is required to anticipate risks and empower Boards to make "decisions informed by data insights.

Diversity, knowledge and expertise

- Align Board diversity and inclusion targets with supervisory and stakeholder expectations. Review the Board candidate selection process, succession plan and the remits of the NomCo and RemCo to ensure they appropriately consider diversity (bearing in mind relevant employment law).
- Perform a gap analysis of Board skills/experience and consider how best to supplement them in light of changing regulatory expectations. Third-party assurance or Board advisors can help the Board gain comfort that regulatory requirements have been met and ensure debate is informed.

10. They think it's all over...it isn't yet

Firms must complete existing regulatory programmes and address re-emerging concerns

Actions for firms

Resolvability

- UK banks should ensure that their first public RAF disclosures are concise and decision-useful for investors. EU banks should continue to build their capabilities on all of the SRB's dimensions of resolvability ahead of the 2023 deadline.

Regulatory reporting

- Firms should ensure that the governance, controls and standards for regulatory reporting are at least as stringent as for external financial reporting, including clearer application of the three lines of defence and more independent review and challenge.

IBOR

- Firms should ramp up efforts to address legacy contracts and ensure clients have clarity well ahead of contract cessation, including about the potential "cliff edge" for new USD LIBOR contracts from 2022, and continue to focus on active conversion through 2022 and beyond.

International banks

- International banks should engage with UK supervisors to ensure that they comply with the PRA's expectations in good time, while continuing to execute their plans to optimise their legal entity footprint in the EU and UK.

Fund liquidity

- Investment managers will need to demonstrate to regulators that their fund redemption terms are aligned to the liquidity of the underlying assets and that they have robust liquidity management processes.

Banking

Ana Lacerda

Fall Semester 2024

Course: Banking [2206]