

Point of View

Banking Leadership: New Skills Required

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From the Golden Era to the Era of Management

From the early 1990s until the early 2000s running a bank seemed easy. This was the golden era of banking. Interest rates were trending down, allowing credit to grow faster than GDP. And, for much of the period, yield curves were steep. Economies around the world grew, unemployment was low and, as a result, so were credit losses.

In this environment, it was hard not to make big money in banking. Much of the profit came from maturity transformation (borrowing short-term and lending long-term), the growth and liquefaction of the credit markets, and sticky, high-margin retail deposits. In the golden era it didn't seem to matter who ran a bank, as long as they had strong deal-making skills and the discipline to avoid over-paying for acquisitions. Exceptional management of growth and costs might lift return on equity from 16% to 20%, but 16% was pretty good in any case.

In the early 2000s the long run of interest rate declines ended, and banking became a mature business in most parts of the developed world, making it harder to grow and maintain returns. Bankers rose to the challenge: they increased the velocity of the credit business through innovative securitisation, increased leverage, were aggressive acquirers and introduced new high margin products for retail and institutional customers. But many bankers did not rise to the challenge of saying no to bad or marginal loans, pricing adequately for risk, maintaining reasonable leverage, and taking the hard decision to reduce capacity in the financial system when macro-factors required it. The illusion that managing a bank is easy was dispelled.

We know what happened in 2007, although we will spend years discussing exactly why and restructuring the foundations of the financial system so that it doesn't happen again, in the same way, soon. It would have been hard, if not impossible, to take the bold steps required to address the challenges and keep investors happy (and your share price strong) with the global economic imbalances feeding demand for hard-currency fixed income instruments, loose monetary policy at many central banks, and competitors continuing to pursue high-margin growth. But the worst excesses were avoidable.

For the immediate future, and this will probably last at least 10 years, managing a bank will require different skills. Credit will be tighter and less liquid, and rates cannot fall further; indeed, at the short end of the curve, they simply will have to rise, flattening and perhaps inverting the yield curve. The inevitable result will be lower growth in the financial sector. In our recent work on the state of financial services¹, banking CEOs told us that expectations for the growth of profits had fallen by nearly 40% across the industry. We think it could be even worse.

¹ State of the Financial Services Industry, 2009, Oliver Wyman.

Credit losses will be higher – both those coming from the structured credit assets still in the system, but also those normal credit losses driven by the recession, and which typically lag a financial crisis by two to three years. Regulatory scrutiny will also be extraordinary, including the imposition of higher capital and liquidity requirements, which in combination with lower profitability is going to depress returns to shareholders across the industry. Some banks with capital to deploy – either because they avoided the worst excesses, or have found government and other sponsors to help them through – will have higher margins, driven by reduced competition and more sensible pricing of risk, to counter the general decline in industry profitability.

For investors in financial services, the new era will require careful selection of investments, rather than allowing for industry bets. The distribution of returns and valuations between banks will be stark.

You could argue that given stronger regulation of risk and capital and lower expected growth, bank management should be easier. Regulatory capital may, in the future, exceed economic capital so bankers would only need to optimise within regulatory constraints rather than defining their approach to risk and return. But it's not that simple. Regulation will evolve and be influenced by bank leaders and investors still need to understand a bank's approach to risk. The activity around new risks will once again outpace regulatory control. Bank leaders will need to start preparing for the next crisis that the new regulations will not prevent.

In this context, I offer seven suggestions for the leaders of the world's banks.

#1: Get on top of the public policy agenda

Having a government relations department is not enough. In the next five years, you will need personally to understand government objectives, the evolving regulatory landscape and other interventions in the business which could include controls around pricing, compensation, business model and geographical profile. The era in which domestic banking regulation was largely insulated from global developments, beyond a varying level of compliance with the Basle framework, is over.

There are several practical ways to ensure you stay on top of the public policy agenda. Have your outside legal advisors brief you as well as your General Counsel. Set up a war-room to monitor global public policy developments and plan for how to influence and respond to them. Brief your Board regularly on your views and plans with respect to regulation and other government intervention in banking. And learn how to lobby and influence because this will be part of your job.

The government is now a much bigger part of the banking system in almost all countries, and there is a danger that political populism will swing the regulatory pendulum too far. Bank leaders will need to play a strong, even if unwelcome, role in shaping the future regulatory architecture. Only a combination of public policy makers and bank leaders will be able to find the right balance, one that lowers systemic risk without undermining the broader contribution of banking to economic growth.

#2: You and your Board are responsible for defining the bank's risk appetite

If we end up with a sensible global and national regulatory framework (one that doesn't turn banking into a utility and remove bankers' need to manage risk), then defining risk appetite will be a core part of your job.

The phrase risk appetite is overused and not well understood, but it doesn't need to be complex. To define risk appetite you must answer two questions.

First: what types of risks does your bank understand better than others, and how are you going to make money managing those risks? Banking is a risky business and an important source of differential returns is assessing and managing risk better than your competitors. Are you better than others at managing domestic credit risk? Liquid markets risk? Illiquid markets risk? Country risk? This question needs to be answered by the CEO, understood by the Board, and communicated to employees and shareholders. The idea that your institution is superior across the whole spectrum of risks will not be credible. Once you specify the risks you are advantaged at managing, you must stick to your guns when subordinates propose taking risks in areas that you do not understand or where you lack any relative advantage. Your Board must also hold you to account and challenge activities that entail taking other types of risks. In the 1990s, this may not have mattered as most risks came good, but it matters now.

The second question is how much risk you are going to take or, put differently, what is your risk/return profile? Are you running a hedge fund with shareholder capital or do you aspire to be a utility with stable but lower returns? There are many right answers here (any point on the efficient frontier) but your specific answer needs to be developed, articulated and understood by employees, shareholders and others who are interesting in bank or system stability, and monitored by your Board.

If you or your Board can't answer these two risk appetite questions clearly, you aren't doing your jobs.

#3: Make sure the governance of the bank holds your hubris in check

In most areas of business, “geniuses” are ultimately exposed as having a wonderful combination of insight, luck and timing. Accept that you are not a genius and take guidance from your customers, staff, management team and Board. If you have filled your Board with cronies and weaklings or your management team doesn’t challenge you, you have weakened your bank and, ultimately, your ability to succeed.

Ensure your Board has powerful compensation, audit and risk committees, comprising people with more than a superficial understanding of the issues they are being asked to oversee. They will undoubtedly make life tougher for you in the short term, but you should welcome the scrutiny. Acquisitions and other major changes require a strong internal strategy group to challenge your thinking. And these debates should take place without horse-trading, side-deals or fear of challenging the leader’s ambitions.

Finally, find ways to introduce contrarian thinking into Board and management discussions. Seek out maverick views that challenge your own views and facilitate debate. Have Roubini come to your Board and tell you that the sky is falling even if you think he is wrong. If you do this, you may notice the credit and market exposures that you were not thinking about, and also be sensitised to broader elements of operational risk you hadn’t considered.

This approach requires confidence and the willingness to debate rather than over-valuing consensus and loyalty. It also helps you think about big picture, structural risks. As a bank leader you must find ways to question the operating assumptions you are making, not just fine tune the performance.

#4: Own and enforce the compensation principles of the bank

You must own and enforce compensation principles and not leave this task to the Human Resources team. The Institute of International Finance (IIF) has put forward a sensible set of principles, which Oliver Wyman helped develop, and they are a good start for any bank CEO. Ensure you do the following:

- Have clear compensation governance throughout the organisation
- Use risk-adjusted performance metrics
- Demand that some compensation is put at risk against future results
- Build long-term incentive plans that manage the “trader’s option” and re-enforce collaborative behaviour

If you can get ahead of the competition in this area, you can start to use compensation as a competitive weapon, rather than treating it as a problem.

#5: Manage the egos of your wholesale bankers

Some of the brightest minds of the last generation migrated to wholesale banking, partly for the intellectual challenge and partly for the money. Your wholesale bankers provide you with important information from the markets, as well as energy, innovation and growth. But most wholesale bankers overestimate their personal contributions to financial success. Do not become controlled by them or afraid of them. If they push too far or have unreasonable demands, fire them or let them leave. You can replace them.

#6: Seize the high ground by ensuring that retail customers are treated fairly

One of the biggest financial scams of the last 15 years has been the use by banks of sales pressure masquerading as unbiased advice. This has been prevalent in almost all aspects of retail financial services, from the sale of sub-prime mortgages to people who clearly could not afford them, the aggressive extension of consumer credit, the misleading use of performance league tables to sell richly priced mutual funds, and the sale of complex structured investment products to customers who did not understand what they were buying. Even without a financial crisis, these techniques would ultimately have led to a collapse in trust in financial institutions.

Rebuilding trust will require developing a culture of customer advocacy across the organisation, and will inevitably lead to changes in product strategy and design as well as changes in sales training, processes and incentives.

Put another way, competition in retail has often been about pushing product hard. In the new environment of regulated pricing and increased consumer protection, this will be much harder to do and competition will be based on knowing and serving customers best. We expect the winners to be “customer champions” with a strong sense of their core customer franchise, a simple sales and service model and the operational competence to deliver it well.

#7: Fire unethical staff

Across the board, trust in banking needs to be rebuilt. Accept occasional failure in business endeavours but do not accept excuses about ethics. Part of your job is to mentor and teach, but you cannot teach morality to adult bankers – if they do not already have it, you are unlikely to instil it in them. Your scrutiny of ethics should cover not only how your staff deal with customers but also how they deal with each other.

The banking leaders of the next decade will need to spend more time understanding and influencing the public policy agenda including direct lobbying. More work and effort is required around overall bank governance involving changes to Boards, Board committees and internal management processes. While the principles behind the required compensation changes are clear, the implementation will require the guidance and commitment of the CEO. Wholesale banking still has a major contribution to make to most banks, but it requires strong management of its management. Retail banking requires a new approach based on the ability to address customers' needs, not just sell them products.

These new skills are in addition to the obvious business-as-usual skills required to manage a bank through a downturn: the ability to take out costs (both to respond to the cycle but also to the structural reduction in the size of the industry), to sharpen credit and collections processes, to strengthen liquidity, all the while continuing to innovate and invest in the core franchise.

Those leaders who can grapple with the new management challenge may not replicate the returns of the golden era, but they will greatly outperform their competitors.

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