

Developments in the Business of Banking

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1. Introduction

There are four core components which make up the business of banking and each has been undergoing dramatic change in its own right. They are: credit, savings, payments and risk management. These four elements used to be closely interrelated, both in an operational sense and in a financial sense. However, in the last decade or so, banks have increasingly looked at each of the core elements on a stand-alone basis. New players have entered the market, and as a result banks have become more competitive and more rigorous about the investment and pricing decisions being made in relation to each of the core elements.

Further, new technology has allowed the entry of new niche marketers resulting in each of the component businesses undergoing disaggregation. Whereas previously banks competed at each stage of the business system, they can now choose to compete within that business system.

Timely identification of the forces causing the dramatic changes and of the trends towards greater disaggregation, and their likely financial implications, is crucial for the ongoing development of profitable business strategies for a large bank such as Westpac. The challenge is to rigorously assess the businesses the bank is in, identify where its real strengths and strategically critical roles lie, and to capitalise on these.

Banks must very precisely identify the areas of business where they have or could have some advantage, and they must rework these and build on them, utilising whatever systems or technology are available to ensure they keep pace with international best practice. Similarly, there might be whole categories of business where it no longer makes much sense for banks to compete from the perspective of profitability or the efficient use of capital. Banks, like other corporate entities, have to recognise that what once may have constituted a fundamental component of their business, may no longer make any economic sense to perform, either because customer requirements have altered or because someone else can do it better. Let me illustrate by taking a brief look at each of the four core elements of banking.

2. Credit

Banks have always been suppliers of credit to worthy borrowers with the capacity to undertake and finance productive investments. The business of providing credit is made up of origination, funding and servicing. Each element of this business requires different sets of skills and qualifications. A large bank such as Westpac can add real value to the origination and servicing portions of the credit business, but not as much to funding all credit business.

The origination side of the credit business firstly involves finding the customer. Getting a customer on the books requires selling skills, be the target an existing or a new

customer. Over the last decade, banks have developed these selling skills and they have also developed new, more cost-effective channels for selling by using mobile lenders and direct marketing, including systematic use of the new sophisticated telephone banking centres. Thus, while banks may no longer have an exclusive franchise on selling credit, they are potentially well placed to compete effectively provided they carefully segment and have in place the appropriate credit-origination skills. Their large customer base can provide them with a distinct competitive advantage.

Credit origination involves assessing the risk, understanding who is and is not creditworthy, structuring the credit (pricing, length of loan, variable/fixed rate) and understanding the cashflows sufficiently to know how the money will be paid back. Highly analytical and knowledge-based skills are required when trying to assess risk and evaluate the probability of repayment. The more experience you have in dealing with large volumes of credit business, the less the likelihood of getting caught out with bad risks. And the greater the number of lending propositions that are assessed, the greater the scope for introducing time and money saving formula-based approaches to the origination process. Banks have developed and refined these skills over a long period of time.

The servicing side of the credit business is also where experience and economies of scale come into play and where costs can be lowered by introducing processing efficiencies. Servicing credit is all about ensuring that the monthly credit payments are made and that the paperwork is kept up to date and accurate. Servicing credit involves information management through efficient processes and technology, and systematic and rigorous debtor management.

A bank with a big customer base and with centralised, highly efficient credit assessment and processing capacity is well placed to carry out both the origination and servicing sides of many credit businesses, not only for its own customers but potentially for other financial institutions whose size does not warrant investment in such efficient backoffice infrastructure.

However, banks, big or small, are less well suited to funding whole categories of credit business. The best sources of funds for credit are institutions that pay little or no tax on their earnings and institutions which do not have to put up their own capital when providing funds for credit. A bank has to set aside capital for any loans it keeps on its balance sheet, and it then has to pay tax on the interest earnings. On the other hand, a mortgage trust or superannuation fund has no similar capital requirements and the latter is also in a tax-advantaged position which allows it to accept a lower gross return, helping bring down costs for borrowers.

Banks also incur regulatory compliance costs if they want to fund credit via deposits, which costs must inevitably be factored into the pricing of the deposit and/or the credit offered to the borrower. All in all, in the current taxation and regulatory environment, banks are not as well positioned to fund all types of credit as cheaply as are other institutions, particularly consumer credit that can be standardised into a commodity product and aggregated for securitisation. Banks already can and will increasingly securitise such loans, just as non-bank mortgage originators securitise them, and then leave it to non-bank institutions to take up the securities.

In the same vein, most large corporates with good credit ratings discovered years ago that to use the bank as a middleman for their standard borrowings was often inefficient and that they could lower their borrowing costs by going to the securities markets directly.

It is mostly borrowers with unique, non-standard credit needs that will rely heavily on banks and finance companies for their funding requirements. Rural enterprises, the self-employed and small and medium sized businesses which do not have access to the securities markets and whose credit requirements are far less easy to standardise for securitisation will all continue to look to banks for their credit needs. And these loans will be financed in the same way as they are now: on banks' balance sheets, not by the securities markets. Similarly, even large corporates will still need to deal with banks for tailored, non-standardised credit such as a bridging loan, or even short-term working capital.

In summary, banks will continue to perform a useful role in funding the credit for the non-standardised segment of the commercial and personal borrowing markets, but their capacity to perform the same role efficiently with standardised consumer and large corporate credit is far more limited.

Not only is the overall credit business becoming increasingly disaggregated into its component parts of origination, funding and servicing, but the component parts themselves are undergoing further disaggregation. The challenge for a bank is to clearly identify the elements of the credit business where it can compete effectively, and to appropriately cost and price any activities it undertakes. Cross-subsidisation between the components will not be an option, since efficient third-party providers will swiftly appear to offer better value to whichever customer or product segment is paying for the cross-subsidy.

3. Savings

The flip side of the credit business is the savings business. People with excess funds for present day purposes or a requirement to build up capital for the future set aside money via savings. Savers choose where to invest their funds based on some combination of yield, likely capital appreciation, liquidity, security, income stream and tax-effectiveness. And there are many vehicles to choose from: banks, building societies and credit unions all offer savings accounts and term deposits, but other options available include listed shares, property, unit trusts, mutual funds, superannuation funds, single-premium products, antiques or works of art or even newer tax-effective investments such as infrastructure bonds.

Despite the increasing choice of savings options, banks will continue to play a critical role in providing a highly secure and liquid medium for savings for those segments of the population that are more risk averse or with high liquidity preference. But it needs to be recognised that intermediation in the savings process by depositories such as banks is costly and the product set a bank can manufacture, in its role as a bank, is relatively limited in the current regulatory regime.

Historically, banks have intermediated in the savings process on three dimensions: they have intermediated on size, risk and time. By contrast, banks' main competitors in the savings arena, the funds managers, intermediate only on size leaving the investment

and interest rate risk with the investors. In the past 15 years, relatively few major financial service organisations have failed and this has helped foster a lack of understanding of the precise risk intermediation implicit in the competing products offered by banks versus non-banks. But the good fortune and good management that has allowed Australia to have a relatively healthy financial sector does not diminish the differences in the type of risks associated with different categories of savings products.

Both banks and funds managers intermediate on size, pooling many small investors' savings into larger volumes of funds suitable for investment in higher return and more diverse alternatives than the individual investor could alone orchestrate. However, intermediation on risk and time is typically only carried out by banks and similar deposit-taking institutions.

A bank guarantees both the capital and the interest on all its savings products. However, the safety of a bank deposit, the capital guarantee, comes at a cost. That is, the regulatory requirement for a bank to hold 1 per cent of deposits in non-callable deposits at reduced rates of interest and 6 per cent of liabilities in prime assets. Further, when a bank offers a fixed rate for a term deposit, it, not the investor, bears the risk of interest rate variability. The cost of taking on this risk, combined with regulatory compliance costs, lowers the return for the investor.

By comparison, non-bank organisations offering investors the option of saving via a fixed-income trust do not have the same regulatory imposts put on them. Nor do they bear the risk of any credit deterioration over the period of investment. Hence, their capacity to hold out the promise of higher returns is greater than it is for banks. However, the consumer needs to understand the risks associated with the higher return.

Banks also intermediate on time, particularly as regards at call deposits at a particular interest rate. The investor expects instantly withdrawable funds, perfect liquidity, while the bank may have invested those funds, or a proportion of them, in a longer term asset such as a mortgage. It is the bank's problem to manage the timing mismatch, not the investor's. In comparison, far greater restrictions apply to most investments offered by funds managers in terms of the flexibility the investor has to withdraw funds and be guaranteed a particular yield or a particular capital sum. The interest rate risk and associated price volatility is borne by the consumer.

A bank also has less flexibility in the type of savings vehicles it can assemble for investors. A mutual fund or balanced trust investment can offer higher prospects of return than can a bank deposit because it can invest not only in fixed-interest investments and housing mortgages, but in commercial and retail property and equities, either in the domestic or international markets.

Thus, from the customer's perspective, intermediation in the savings business seems to be more efficiently handled by funds than by banks. Less intermediation on risk and a wider array of investment options give rise to higher yield prospects, which are attractive to many consumers. However, the increased level of risk in non-bank savings products is not always recognised or acknowledged by the customer.

In addition to being free of many regulatory imposts and their associated costs and having greater freedom to invest, funds managers also do not have to carry the overhead costs of the banks' branch networks. The costs of the branch networks have traditionally

been absorbed by banks in their pricing of savings and credit products, but in today's competitive environment there is much less capacity to do so.

However, while the existence of an expensive branch network does not make a positive contribution to the pricing of a savings product, it does offer banks a customer acquisition and product distribution advantage that most funds managers do not have. Banks have enormous customer bases into which they can tap and they are developing increasingly efficient alternative distribution channels through which they can gain access to their customers and vice versa.

In the current regulatory environment, banks should perhaps pay more attention to these distribution strengths when devising strategies for their savings businesses. For some banks it may make sense to develop their own subsidiary funds management businesses to manufacture products for their own distribution. For others, the optimum strategy may be to offer their distribution capacity for use by external specialist funds managers rather than build or try to maintain their own funds management businesses.

The trends in the savings business will continue to be towards disaggregation of the funds manager and distribution function and to more explicit recognition of what is and is not absolutely safe when it comes to savings products. Banks will have to continue educating consumers to understand that both the guaranteed capital and return associated with bank savings products and the convenience of branch access for savings products come at the cost of yield.

4. Payments

The payments business is all about helping people, companies and governments move value. The payments business is really made up of two components: one element comprises the various means by which the many different forms of payments are physically transacted and the other comprises the means by which all the transactions are settled or cleared. Until the early 1980's, both parts of the payments business were effectively the sole province of banks. Banks' access to the centralised clearing system, allowing for the settlement of all payments, and their exclusive ability to be able to offer cheque accounts (which once were virtually the only means by which companies and individuals could participate in the payments system), were a source of great value to banks. However, the value and cost that customers get from being able to access the payments system was not well understood, and still may not be. The lack of understanding resulted in banks not adequately pricing transaction services and in cross-subsidies evolving between the transactions/payments part of banking and the savings and credit businesses.

Because historically there was no interest paid on cheque accounts, banks could afford to build or lease lots of branches in order to make it convenient for their customers to open cheque accounts. Indeed, the only way in which banks could market effectively and ensure a steady growth in business was to continue to build new branches wherever there was a newly identified customer base emerging. While cheque account holders did not receive any interest on their balances, they equally did not have to pay for the convenience of being able to go to a branch in any suburb or country town and have branch staff attend to their needs.

A variety of developments have had an impact on this once simple, bank-run payments system. First, subject to regulation, other institutions such as building societies and credit unions were allowed to become participants in the transactions part of the payments business. Banks no longer were the only organisations to offer cheque accounts – you could get access to a cheque account via your building society or credit union or as an add-on to your cash management trust investment. Second, the restriction on paying interest on cheque accounts was lifted. In so doing the main source of revenue for maintaining and further expanding the branch network was lost. The dilemma was soon faced: customers' preference for the convenience of branch access versus their perhaps even stronger preference for earning competitive rates of interest on cheque accounts and all other deposits. The dilemma was further compounded by customers having learned not to associate use of the payments system, including making transactions in branches, with any costs.

In today's environment, cross-subsidisation will ultimately have to end. Customers want competitive pricing to be available for each of their credit and savings products, and this will make it impossible for banks to continue using the margins in the savings and credit businesses to pay for the costs associated with providing a payments, transactions and settlement service. However, the market is still grappling with trying to appropriately value the payments system and apply prices to its various components in a manner that truly allows it to be a stand-alone business.

The challenges of pricing transaction services are great. In a normal business increased usage or purchase of a product will add to revenues and eventually, after the break-even point is reached, it will incrementally add to profitability. In the case of banking services, increased cheque writing, branch visits and ATM usage adds to a bank's costs but not necessarily to its revenues because revenues are mostly dependent on the size of the balances in the accounts. Equitable pricing of transaction, savings and credit services is required from the customer's perspective and it is also required if a bank is to make correct strategic decisions and have flexibility in its capacity to adapt to a changing market.

Technological innovation is also changing the way transactions can be carried out. Electronic funds transfer, automatic teller machines, EFTPOS, increased usage of debit and credit cards, stored value cards, telephone banking and computer banking all have the potential to offer greater convenience and more cost-efficient payment solutions. Technology also offers the potential to reduce the inefficient and wasteful movement of money by means of tonnes of paper and millions of staff hours of processing cash and cheque transactions in hundreds of branches and backoffices.

Having the ability to deposit a cheque and withdraw funds at an ATM at 11.00 pm rather than between 10.00 am and 3.00 pm at a branch is a new, and obviously more convenient way of facilitating payments between parties. Technology does not take away the requirement to make payments. Rather, it offers the prospect of much greater convenience for the execution of transactions, and of lower costs, provided banks are able to substitute the new for old. What banks cannot afford to do is keep the old branch network for facilitating payments and simply add on the new technology. New players in the market will invest only in the new technology and their costs will be commensurately lower. For banks to be able to compete they must somehow substitute the new for the old,

to arrive at a much better balance of costs and consumer choices. Customers are not prepared to pay the cost of operating both the old and new technologies.

Every country needs an efficient and safe payments system, one that can always be relied on to deliver the promised value exchange service. Banks are good at facilitating value exchange via the payments system and have a record of innovation and unquestioned reliability in this area. It was banks that introduced EFTPOS, increasingly sophisticated ATMs and on-line access to bank accounts for corporate customers. The banking sector will continue to make further investments in technological innovations.

Ongoing developments in computer and communications technology and the trend that has developed for non-banks to participate in various forms of the transactions part of the payments business will result in more and more non-bank competitors seeking to earn revenues from some portion of the payments system. Taxi companies and government transport organisations are issuing prepaid cards, retailers are setting up their own EFTPOS networks and Australia Post and DigiCash are providing registration and verification systems for Internet payments. These developments are all indicative of the change and diversification the payments business is undergoing.

That said, for entities that are not banks to play a core role, in particular a settlements role, in the payments system in the same way that banks do is not something that any country's regulators will undertake without careful consideration. For a payments system to operate effectively there must be complete integrity in the clearing mechanism that allows counterparty settlements to take place. A non-bank organisation would have to have a very large and strong balance sheet and be prepared to have its activities suitably regulated in some way if it was to become a core participant in the payments system in the same way that banks are. Gaining participatory access to the payments system comes at a considerable cost and that cost would have to be borne by any would-be new participants if the system's integrity is to be maintained.

The payments business is much like a chain, with value exchanged and honoured from participant to participant. Like any chain, it is only as strong as its weakest link. The international distress caused by such obscure institutional names as Bankhaus Herstatt, Penn Square Bank and Drysdale Securities, underline the critical components of strength and integrity as prerequisites for payments system participation. Don't forget the payments business is both enormous and essential. In a country like Australia it is not unusual for all our payments systems together to turn over the equivalent of our annual GDP every five days.

5. Risk Management

Risk management has always been a core part of the business of banking. A bank's internal risk-management policies and activities are essential to its business. They are required to ensure adequate liquidity, appropriate matching of assets and liabilities, maintaining the value of the loan portfolio, preserving the integrity of deposit funds and payment flows and ensuring that the overall operations are run efficiently and with integrity.

As a result of having to develop their own risk-management capabilities, banks have also been in the position to be able to offer their corporate customers risk-management

products and services. Banks offer a wide array of treasury products that help corporate customers manage their interest rate, foreign exchange and commodity price risks.

From this point it was a logical step for banks to move into offering consumers risk-management products to fill out the overall package of available financial services. Products such as life insurance and home and car insurance are logical adjuncts to the savings and credit products banks offer their customers. But a bank needs to carefully assess the most appropriate way of participating in this broader risk-management market.

With risk-management products there is an underwriting function and a distribution function. An experienced specialist insurance company is often better placed to carry out the risk assessment, the actuarial evaluation and pricing, than is a bank, because the development of expertise and economies of scale operate in insurance just as do they do in banking. The insurance company may then choose to carry some of the risk itself and the rest it will lay off with other specialists. A bank's balance sheet is not necessarily as well suited to carrying insurance risks.

On the other hand, insurance companies may be less well placed than banks to carry out the distribution function for certain risk-management products. Insurance companies do not have the extensive customer access which banks have nor do they generally have the range of relatively low-cost, newer distribution channels that banks have been developing for customer access.

The continuing evolution of the financial services sector will see further unbundling of risk management into its component parts, with each part being undertaken by those organisations that can carry it out most efficiently and at the lowest cost. There will be further disaggregation and more market segmentation and specialisation in both the underwriting and distribution functions. And while the overall boundaries between what constitutes an insurer versus what constitutes a bank may continue to blur, the blurring will not necessarily extend to which organisation is best suited to administer or provide one of the disaggregated parts of each industry. The skills that it takes to be really good at underwriting and even distributing insurance products are not necessarily the same as the skills required for credit or savings or making the payments system work with complete integrity. Just as not all banks would make good insurers, so too not all insurers are destined to be great bankers.

6. Conclusion

There are dramatic changes taking place in each component of the businesses within banking. This requires the development of new skills and new ways of doing business. If banks are to be truly competitive, each element of their business will need to be carried out to a standard that matches the world's best practice.

Whether or not a bank is operating in the international arena or in the domestic marketplace, international standards will apply to the provision of competitive banking services. There are developments and trials taking place around the world aimed at getting each aspect of banking more efficient and less costly to provide. The technology that emerges has no national boundaries, therefore future standards will be set by whatever is international best practice in each unbundled area of the business.

It would be foolish for any bank to think it could continue to carry out all the current functions of banking at a standard that matches international best practice. Each bank, or financial services provider, will need to carefully identify where the competitive dynamics sit for its particular circumstances, identify its strengths and develop these to world standards. In the areas of its business where it cannot match international best practice, the bank or financial services organisation will need to look for solutions in outsourcing and/or the formation of operational and financial alliances, or consider withdrawing altogether.

Successful banking in the future will require a deep understanding of the four components of banking and of the different trends and evolutionary paths emerging in each. There will continue to be more disaggregation and more disintermediation, and new kinds of disintermediation. But far from banks being left behind the emerging developments, banking will continue to remain at the centre of all the change. Banks, as institutions, have existed and evolved for hundreds of years. They have consistently met their community's needs for credit, savings, payments and risk-management services; and have adapted these services to embrace whatever new technologies have emerged: from telephones to computers and now the Internet. Despite the many existing changes we see ahead, the world still needs institutions to deliver the component services we label as 'banking'. The banks who will prosper in this environment will be those which understand what is going on and can adapt their businesses accordingly.