

The background of the top section of the page is a panoramic view of a city skyline, likely London, featuring prominent buildings like the Gherkin and the Shard. The sky is a clear, pale blue.

Turning a corner...

Changes still to come in banking

Financial Services

Jeremy Anderson was recently appointed Global Chairman of KPMG's Financial Services practice. Alison Halsey spoke to him about how the banking industry has been affected by the financial crisis.

Alison Halsey: An interesting time to take this role on, Jeremy. How would you characterize the way that attitudes to banks have changed as a result of the crisis?

Jeremy Anderson: I think there has been a really significant change, and it's primarily the result of two separate drivers. First, the scale of the rescue efforts that governments have had to make has put an enormous strain on government balance sheets, and this will affect taxpayers for years to come. It's inevitable that there's now an intense focus on trying to ensure that the next crisis doesn't have anything like the same impact, especially on the real economy.

Second, there's clearly a lot of criticism and anger from the general public. Many people are suffering real pain from unemployment, falling asset values and other recessionary consequences. So the crisis has focused attention on the role of banks in a very public way. Trust has been severely damaged. Banks now have to

respond, rethink their responsibilities and operating models, and regain their 'licence to operate'.

AH: Looking at it dispassionately, to what extent do you think the criticism directed at banks is justified?

JA: Well, it's a fair criticism that during the boom, very few bankers realized the fragility of the global economy, which was based on unsustainable increases in house prices and cheap borrowing, which in turn was driven by the political imperative of widening access to home ownership in the US. With hindsight, there were plenty of warning signs, and they should have been taken much more seriously.

AH: Do you think people have now got the message, and understand the implications of the crash for future economic growth and personal wealth creation?

JA: That's very difficult to answer. Certainly, people now have a much more sober, more realistic attitude. Many more people are unemployed,



with all the hardship that brings. Even those who are better placed are cutting back spending, wondering whether they can retire as they previously planned, rethinking all kinds of economic decisions.

But injections of public capital, government guarantees, expansion of the money supply – while absolutely correct in my view – do have the side effect of cushioning us from the full impact of the adjustments which will ultimately be necessary. Spreading the pain over a number of years, although it will still be painful, lessens the immediate shock. One of the key indicators, in my view, will be personal savings rates. Will they continue to rise, as they have begun to do since the crisis? If so, this will signal a real change in attitudes and expectations.

AH: There has been a lot of discussion about a new ‘back-to-basics’ model in banking. What to you are the core functions of the banks?

JA: First of all, we should remember that banks are absolutely essential to the functioning of all economies. They provide vital services in maturity transformation, credit provision, risk management, storing and protecting the value of savings and facilitating transactions. By these means they act as an engine of economic growth and hence social well-being, playing a key role in helping to lift 400 million people out of poverty around the world, over the last 30 years¹. This wouldn’t have happened without a global financial system, global investment, global trade. And in turn, this system couldn’t function without investment banking, financial engineering, financial trading and so on. Securitization got a very bad name at the height of the crisis. But it’s a fundamental part of providing credit to businesses.

AH: Do you think the balance between banks’ objectives has changed as a result of the crisis?

JA: Perhaps we’ve seen the end of some of the more esoteric banking activities. But we don’t live in a simple world. Complex problems require complex and innovative solutions. Many companies need access to sophisticated hedging and risk management strategies: without them, sensible business management would be impossible. If derivative products are penalized by having to carry higher capital requirements, then the real economy suffers higher costs. The difficulty is to discriminate between innovations which genuinely meet clients’ needs, and those which are divorced from underlying economic reality, pure financial innovations driven for the benefit of the financial markets alone. Here there does seem to me to be a case for tighter regulation and higher capital requirements.

AH: Clearly, banks are businesses which have to be run for the benefit of their shareholders.

But presumably they also have wider social responsibilities. How would you characterize these, and how should banks negotiate the trade-off between profit and responsibility?

JA: At one level, I don’t think banks are in essence any different from other businesses. No business of any standing can be run – or is run – solely with a view to maximizing short-term returns to shareholders. Long-term sustainability is the key. And this means responsibility to stakeholders, to society at large and the wider environment. All businesses exist to make money by serving customers, but increasingly they have to do this in a socially responsible way.

¹ www.dfid.gov.uk, Department of International Development, May 2010.

In the long term, the interests of shareholders, customers, regulators and governments are congruent, and are all best served by socially responsible performance. It's in the short term that there are difficult trade-offs to make, say, between maximizing earnings and sustaining socially beneficial but low-profit lending.

AH: Banks have been criticized over the last 18 months for focusing inwards, and for concentrating on rebuilding their balance sheets – to the detriment of businesses who have been starved of finance. What role do you think banks have in supporting the economic recovery?

JA: It is inevitable that banks had to focus on rebuilding their balance sheets. It's also an unfortunate but true fact that as the economy deteriorated, prospects which previously presented an acceptable risk became too risky to fund. Looking ahead, I personally find it difficult to accept that banks should be forced to lend when it is not in their rational economic interests to do so. That takes you on to the path towards state-directed banking, and all the evidence proves that the result is a massive increase in bad debts and long term economic damage.

As we move into recovery banks are caught in very uncomfortable tension between the conflicting demands of governments, regulators, customers and the public.

AH: We've been talking generally about banks' social responsibilities. How would you say this should translate into their responsibilities to individual customers?

JA: Keeping close to the customer is absolutely essential. Any business will suffer in the medium and long term if it doesn't. I think there's a good case that in recent years pressure to cut costs and streamline has led many retail banks to de-personalize their customer interactions. But we're going to see a lot more competition in the retail market in future. New entrants are differentiating themselves by product design and packaging, by customer service, by market niche, and this can only improve the customer experience.

Part of this, however, has got to involve a new transparency and honesty between banks and customers. Banks have got to be honest with customers, appraise their prospects fairly, be transparent about decision-making, about the nature of products, about fees and charges and so on. Banks have to return to serving customers, and treating them fairly, rather than seeing them simply as generators of revenue streams and as targets for sales teams. For banks that focus on this, satisfying regulations which call on them to treat customers fairly will be a consequence of good business, not a constraint.

AH: One of the biggest issues exercising fiscal authorities, regulators and bankers alike is the nature and extent of future regulatory changes. How do you think the balance should be struck between external regulation and responsible banking practice?

JA: However much one might regret it, the stability of the financial system is too important to be left to the private judgements of senior executives and boards. External regulation is essential, and tighter regulation is inevitable. I do worry, though, that excessive or ill-conceived regulation may squeeze

entrepreneurial flair out of our economy and our society. People still need the freedom to take risks, to make decisions and ultimately also to fail.

Similarly, external regulation can never absolve bankers from the need to act responsibly in accordance with their own judgement. No regulator can take the place of judicious business judgement and risk assessment. So a balance needs to be struck, and the worst excesses of knee-jerk populist regulation have to be avoided. It's also vitally important that there is a level playing field, and that the opportunities for regulatory arbitrage are minimized. We need to beware of the danger of unintended consequences.

At the moment, I'm encouraged that regulators and government authorities seem to be taking a sensible and measured approach.

AH: How do you think the role of external directors is going to evolve?

JA: Regulators are paying a great deal of attention at the moment to the experience and background of non-executive directors, and their understanding of financial markets. This is not surprising. One of the unfortunate facts revealed by the crisis was the general lack of understanding at both board and executive level, about the true risks of the products the banks were buying and selling.

The job of external directors is two-fold: to scrutinize what is put in front of them, and address the wider implications. This requires sophisticated understanding of financial products and markets. But it also requires a degree of independence of thought. Diversity of background and experience is on the whole a good thing. I'm worried that

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diversity will be squeezed out, and that in the end this will actually encourage the kind of group-think which led to the collective delusion behind the crisis.

AH: Inevitably when banking is discussed, the issue of remuneration raises its head. Do you think there is a broader ethical dimension to remuneration which banks need to take into account?

JA: I don't think any employer willingly pays massively over the odds for talent. Banks work in a global market for executive talent, and both people and money are very mobile. Like it or not, there is a market rate for the best people. Because they can generate large profits, they have a high value. What is important is that that value has to be solid and sustainable to justify high rewards. We have in a sense, to distinguish between 'good' profit and 'bad' profit, and pay for one but not the other.

So moves towards greater performance recognition, multi-year deals and clawback arrangements are all going in the right direction. The important thing is that any system of remuneration can be defended to all stakeholders, and that it does not distort behavior to the detriment of the economy as a whole. Finally, though, the real way to defuse the remuneration issue is for bankers to be seen to be acting responsibly, reliably, safely and for the public good, and to be playing a major role in contributing to the economic well-being of society. If they can achieve that change in perception, and discharge that responsibility in practice, I think we'll hear a lot less about remuneration.

AH: And a lot more about the customer!

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