What Should Financial Institutions Prioritise in the New World of Banking?

By **SREERAM IYER** and **KHOON GOH**

The world of banking has changed over the decades, and will continue to do so. How should banks respond to the digitalisation wave, increased regulatory expectations and the push for greater governance and controls?

Asian economies remain dynamic and poised for growth, even as they emerge from the years of disruption caused by the global pandemic and slowdown. The region's opportunity for growth in banking and financial services is enabling the development of the region as tomorrow's digital powerhouse.

The core activity of banking – taking in deposits and lending to individuals and companies – has not changed for decades. However, the modern banking system has continually transformed to adapt to a rapidly changing world.

What impact do the current and recent macroeconomic developments have on the business models of banks in the future?

The three major forces impacting the business models of financial services include digital transformation, the need for governance and controls, and increased regulatory expectations.

The shift to digital

Digital transformation is at the top of the agenda of most financial institutions. The pandemic accelerated the rate of digital innovation for all sectors of the economy. Customers were forced to utilise digital channels for everything from banking and financial services to grocery shopping.

Much of that digital shift is irreversible. Some 87 per cent of people who did not use banking apps pre-Covid now plan to stick with them. The trend of "everything digital" is here to stay, and banks are facing increased competition from early adopters, fintechs and non-traditional banking entrants. Many banks that have already embarked on their digital transformations have been able to respond to the consumer demand for innovation, increasing revenue and reducing costs, leading to improved return on equity outcomes.

Despite the relatively high risk of failure in implementing digital transformation (various reports by McKinsey, Bain & Co, BCG and KPMG put the risk at between 70 and 90 per cent), Southeast Asia's traditional banks cannot afford to delay their investment in digital transformation.

These transformations will be expensive for established banks with legacy systems and could disrupt time-honoured operational models. But the arrival of digital-first banks and the digital push by established players will be good news for societies across the region. Access to financial services, especially to underserved populations, will improve. In Indonesia, for example, between 65 and 75 per cent of the population use smartphones, but barely half of its citizens have a bank account.

Consequently, board members and executives need to prioritise their technological engagement within the ongoing regulatory developments. Management time and effort in prioritising investment choices are key disciplines of the future operating business model. McKinsey's research identifies four effective models:

- Regular, full-board engagement as a recurring agenda item.
- Formal, standing technology committees.
- Temporary and/or advisory technology committees.
- Informal engagement on select topics.

When it comes to technology, speed matters, but not at the cost of governance and controls. While it may be tempting to hastily chase the next best tactical platform, the solutions need to be thoroughly evaluated for long-term sustainability. Adapting to meet changing customer expectations and trends in the broader environment is not new for the banking industry.

Challenges ahead

So, what is new?

The challenge financial institutions are now facing is the speed of change. When the artificial intelligence-enabled ChatGPT was launched on 30 November 2022, it reached over 100 million users within the first two months. It is now seen as an existential threat to the ubiquitous Google search engine, whose dominant market position was unquestioned before ChatGPT's release. Companies must increase their investments in cyber, automation and cloud initiatives.

Digital adoption is also a key factor to consider. Digital adoption is not just about signing up customers, it is equally about the internal employees. Hence, the digital adoption strategy needs to be given as much attention as designing a platform. Massive amounts of time and investment have to be spent on the platform of the future. More importantly, communicating and educating people to utilise what is being built is essential.

Besides the implications of digital transformation, corporate governance, macro-economic developments and talent shortages are major challenges that banks must proactively tackle (see "Key Challenges and Approaches for Financial Institutions" on pages 18 and 19). Difficult economic circumstances around the world are pushing boards, management teams and regulators to widen their focus by assessing the overall impact of those challenges.

A shared, promising future

The financial services ecosystem is growing. Regulators, fintechs, big techs and banks will

Key Challenges and Approaches for Financial Institutions

Challenge 1: Failure of corporate governance

The collapse of crypto exchange FTX had wide-reaching implications throughout the economy. Cryptocurrencies and exchanges with exposure to digital assets faced sinking prices, loss of confidence and financial troubles. The spectacular rise and fall of FTX has forever changed the trajectory of the virtual assets sector. Although the broader consequences will take time to unfold, the collapse of FTX demonstrates the dangers of poor corporate governance.

Silicon Valley Bank, the 16th largest bank in the US, failed three days after facing a bank run. This spectacular banking failure highlighted the blind spots that still exist despite the general improvement in corporate governance after the 2008 Global Financial Crisis.

What FTX and Silicon Valley Bank have in common are corporate governance failures resulting in a lack of internal controls. Governance failures occur due to the business model promoting a lack of transparency, poor communication, inadequate oversight and lack of accountability.

The approach

A robust risk management and compliance framework can help identify, assess and mitigate potential governance failures. This should be a continuous process, that is reviewed and updated regularly.

It is important to incorporate an assessment of the external environment at the board level. A company that has poor or limited governance is bound to fail. One approach will be to leverage new-age technology to combat such challenges. Key risk areas such as cyber security require persistent and continuous board oversight.

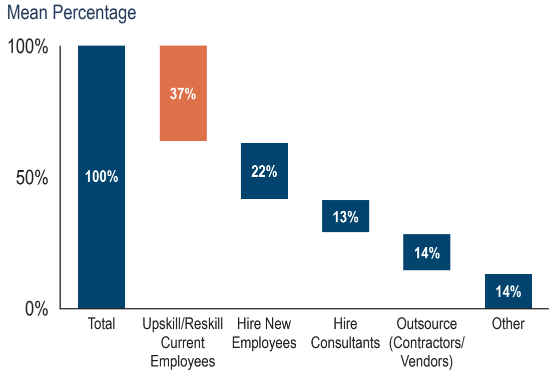
Some banks in Asia are now using a combination of blockchain and cognitive analytics to prevent transactional losses. Others use a combination of blockchain and advanced analytics for perpetual know-your-customer (KYC) monitoring for compliance and fraud prevention.

Asia is a complex market to protect against potential financial crimes like fraud, money laundering, terrorist financing and tax evasion, partly because of the different regulations and legal structures across the jurisdictions. Not only do banks have to know and abide by their native anti-money laundering and KYC compliance regulations, but the business models must also adapt to multi-jurisdictional regulations.

Challenge 2: Supply and cost of talent

Supply and cost of talent remain one of the biggest barriers to the success of digital transformation. Gartner estimates that 37 per cent of the effort to close the gap relates to strategies of upskilling and reskilling current employees (see graph below). Some of the responses are flexible methods of hiring and adopting productivity-enhancing tools, such as deploying low-code or no-code technology.

Ways to Close Talent Gaps



n = 275, all respondents, excluding "don't know"
Q. Thinking about your organisation/business unit approach for talent gap fulfillment in the last 12 months, please estimate roughly what percenta was fulfilled by the methods listed below?

Source: Future of Work Trends, Gartner, 2023

Garner's report on the *Future of Work Trends* 2023 highlights that organisations face historic challenges with a competitive talent landscape, an exhausted workforce, and pressure to control costs. Hiring executives must get savvy to snag in-demand talent, focus on employee mental health and confront data ethics in new human resource technology.

The approach

Banks should focus on a broader staff value proposition, hinging on culture, engagement and employee-friendly policies such as the well-being of employees. Hiring is expected to increase within the fintech payment services, as global travel and overseas tourism resume. Financial services firms will need to hire more hybrid talent, such as professionals skilled in both technology and operations.

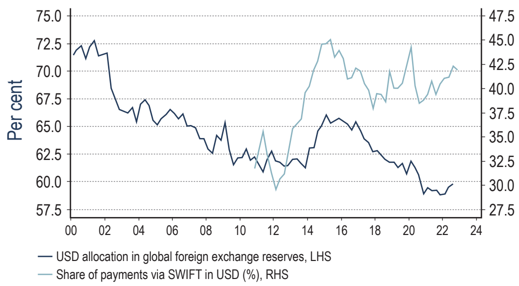
Compliance talent, in particular, will be in high demand, as new fintech and digital banking businesses open in Singapore and the region, drawing talent away from more traditional banking and fund management sectors. While cost is a current issue, challenging siloed-business models to increase productivity is another necessary response.

Challenge 3: Macro development and regulations

When it comes to regulation, one size does not fit all. Government interventions as well as the expansion of safety nets may have undermined market discipline given the fast-changing geopolitical landscape, including the shift from globalisation towards increased nationalism, protectionism and a more fragmented global environment. Part of this is the debate on the future of the US dollar as a reserve currency.

Over the past two decades, there has been a clear downtrend in the share of US dollar denominated assets held in global central bank foreign exchange reserves (see chart below). This fell from almost 73 per cent in 2001 to just under 60 per cent in 2023.

Falling US Dollar Allocation in Global Foreign Exchange Reserves



Source: Bloomberg, Macrobond, ANZ Research

The approach

Regulations drive long-term sustainability. Bloomberg recently reported that in the digital assets space, regulators seek to strike a balance between fostering innovation, providing consumer protection, and preserving market integrity. Often, it is a case of regulating the unknown. Financial institutions will need to be prepared for a less dollar-centric world.

Regardless of one's view about the dollar, there is no other currency that can come close to replacing it as the pre-eminent global reserve currency in the near term. Even the Chinese renminbi's share of payments has stalled at 2 to 2.5 per cent in recent years.

Clear underlying shifts are occurring, including the role of central bank digital currencies, which could impact the dollar's dominance and appeal. Although the renminbi's share in payments has stalled, it could accelerate as non-western countries seek to reduce their reliance on the dollar.

need to work together to modify their business models. The importance of a deliberate ecosystem strategy and its execution will be critical. Firms will need to select whom to partner with and how. But financial institutions need to figure out how to embed and operationalise flexibility into their strategies.

Technology and digitisation will have a profound impact on future-ready business models. To determine the model best suited for an organisation, banks need to ask themselves the following questions.

1. What role does technology play at an enterprise corporate strategy level?
2. How deep is the technical expertise at a board level for the right challenge and for positive investment choices?
3. What is the pace of digital transformation from the top of the house?
4. What are the largest technology risks that could disrupt the operating model?
5. How resilient are the governance models to manage and report such risks?

The opportunities are plentiful. With the right approach, the region's banking industry will emerge stronger and leaner.

To remain relevant, however, banks must reinvent themselves. This requires persistence, investment, and strong commitment. At the same time, banks must balance short-term goals with priorities for the long term. These include articulating the bank's purpose for the digital age, redefining its value proposition, and rebuilding the operating model in response to the changing environment. ■

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