

Crisis Laid Bare Banks' Weaknesses at Processing Information

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For all the wonderment Walter Wriston saw in the power of information systems, the legendary banker also had his doubts about corporate America's ability to harness it.

The former Citibank chairman, in a piece published in American Banker in 1987, observed that "the time needed to bring up major new systems in today's world is no longer measured in months, but in years, and the capital required not in millions, but hundreds of millions of dollars. In the meantime, the world does not stand still, and people playing catch-up are pursuing a moving target that they may never catch."

Almost a quarter of a century later, banks are still playing catch-up. And the inevitable sloppiness that has ensued is catching up with banks.

The financial crisis three years ago unmasked much more than lapsed credit standards and gaps in risk management. It exposed the industry's unpreparedness to switch gears, as needs shifted from loan origination to loss mitigation. It revealed a system that allowed vital paperwork — documents that could determine whether families stay in their homes — to turn up missing or mishandled.

It debunked whatever management science it was that led banks to put products in silos, an arrangement that now poses a sizeable obstacle

for banks trying to get a 360-degree view of customers across product lines. And it reminded the public, already outraged by bailout packages and giant bonuses, of all the little things about their banks that annoy them, like the hassles that can accompany what should be routine matters or basic problem-solving.

In bringing all this to the fore, the financial crisis underscored the other crisis in banking: the weaknesses in banks' ability to process information with the precision and insight needed to match the operational risks they face.

"If you go back 10 years ago, having transactions work flawlessly was a big goal, and I think banks thought they had gotten through that," said Charles Wendel, president of Financial Institutions Consulting. "But it's hard to be a complex organization, and this most recent recession proved it."

Leo Tilman, president of the strategic advisory firm L.M. Tilman & Co. and author of the 2008 book "Financial Darwinism: Create Value or Self-Destruct in a World of Risk," said large banks today are run too much like they were in Wriston's era, a time when the industry was far more staid, and even the most complicated of banks looked streamlined by today's standard.

"The way many financial institutions are managed, structured and operated is still more reflective of the reality of 30 years ago than the current environment," Tilman said. "In today's globalized and interconnected world, managing an institution of complexity and size requires a different decision framework, a different role of executive management and different organizational structures. It requires the entire firm thinking differently and speaking the same language."

At the very least, it should require a reliable translation service. It's hard enough for big banks to manage the disparate information systems they so heavily rely on, from networks for account management and client service to programs for trade settlement and regulatory compliance. The megamergers of the 1990s and early 2000s, the ones that redefined what it means to be a big bank, only added to the complexity of the architecture, which frequently came together in a manner that was more patchwork than planned.

"For the large U.S. banks, especially the ones that have grown through acquisition, it's very difficult. The systems don't talk to each other," said Ellen Zimiles, a managing director at Navigant Consulting who helps institutions with regulatory exam preparation and remediation programs in areas including corporate compliance, fraud control and prevention of money laundering. Her observation easily could apply to a far wider variety of functions within large institutions.

Of course it's not just technology that determines banks' ability to process information. It also involves people: the back-office staff handling databases and paperwork, the front-line bankers making credit judgments in the field, and the executives setting priorities for their organizations.

Rod Taylor, of the executive search firm Taylor & Co., is particularly worried about those last two categories of employees. In the mid-1990s, he started to notice a shortage of young bankers, people who would have entered the work force in the late 1980s, when banks were slashing their credit-training programs to cut costs.

He connects a dwindling in the ranks of well-trained, experienced bankers — and a subsequent shortage of candidates for senior management — with the trouble that many banks had in restraining their lending during

the last credit cycle, and in recognizing when the cycle had started to turn.

"It's part and parcel to the problem," Taylor said. "Historically banks had always required people interacting with customers to have the credit skills to provide an initial screen and to judge credit quality on the front end. A lack of credit skills is one of the reasons we saw a lot of banks move" to a more automated approach that ultimately backfired.

But it was not the technology that caused the trouble. Rather it was human error, on the part of the model builders who tricked the technology into approving decisions it shouldn't have. Jamie Dimon summarized it neatly for the Financial Crisis Inquiry Commission. "Somehow," the JPMorgan Chase & Co. chairman and chief executive testified last January, "we just missed that home prices don't go up forever."

It was an oversight of such disastrous consequences that even those who defend the usefulness of large banks, those who would argue that the institutions serve a unique function in the global financial system, had to wonder about the institutions' competitive advantage.

Retail banking customers have long raised similar questions.

"If you look at any time period over the last 20 years, and you divide the banks into those smaller than \$5 billion versus those larger than \$50 billion, the smaller banks on average achieved organic growth in deposits at double the rate of the majors," said James McCormick, president of First Manhattan Consulting Group. "In other words, surprise, surprise, with all that the big banks bring to the party — they've got branches everywhere, the best technology — who is winning? It's the smaller banks. And one of the reasons why the smaller banks are more competitive on the street corner is that the larger

banks have a tendency to overcomplicate things."

The robust product management departments at larger banks are under pressure to keep innovating, to keep conceptualizing, throwing fresh curve balls to their co-workers in information technology, McCormick said, while IT departments are stretched in ways that sometimes generate frustrations on the part of customers (like when this reporter had to track down the checkbooks that never arrived in her mailbox and learned they had been shipped to an old address, even though the checks themselves were printed with a valid address that had been on file with the bank for nearly six months).

"If my available IT resource is worried about the next bells and whistles, while the IT environment is getting more complicated, all of a sudden the straightforward things that really have importance — like, 'Hey, I'm a customer. Did I get my checks?' — are pushed down the queue," McCormick said. "The ability to simplify and streamline is a major opportunity for most" big banks.

The opportunity was magnified by the sizeable mergers ushered in by the financial crisis. But much of the complexity dates back a decade or more, to acquisitions of banks that themselves were the product of mergers, and of a philosophy that put a bank's return on equity (and, by extension, its attractiveness as a takeover target) above all else, even at the expense of much-needed investments in technology and systems integration.

The consequences of the don't-invest-more-than-you-have-to approach compounded as merged banks merged with other merged banks. An integration done on the cheap by Wachovia Corp. predecessor company First Union Corp. famously drove away 20% of CoreStates Financial Corp.'s customers by the first anniversary of the companies' 1998 marriage.

Aware of the history, Martin Davis, the Wells Fargo & Co. executive who is managing the technology side of the company's integration of Wachovia, was pleasantly surprised by what his team found when it started its work in late 2008.

Both Wells and Wachovia "had been very disciplined ... and [each] had integrated all environments to common platforms," Davis said. "That is very much a rare thing, and what I would suggest is that it's now a competitive advantage." The integration is on track for completion by the end of this year, he said.

Citigroup Inc., which lost out to Wells Fargo in a bid for Wachovia, has not made any sizable acquisitions since the crisis began. But it, too, is focusing heavily on integrating systems — its own systems — after years of neglect. About a year ago, the company expanded a contract with a technology vendor to switch its entire North American banking operation to a core processing application, making it the first of the giant U.S. banks to embark on a wholesale replacement of core systems.

Analysts estimate the multiyear project will cost hundreds of millions of dollars, and Brad Dinsmore, head of U.S. retail banking at Citi, said it will give employees a full view of client relationships. That means customers would need only one point of contact with the company to get service, regardless of which products they want to discuss or through which channel — branch, phone or Internet — they bring their questions.

Dinsmore and other leaders of Citi's North American consumer business meet for two hours every Tuesday to discuss concerns or suggestions raised by clients or staff. Sometimes the sticking point is a technological issue, but sometimes a trouble spot or roadblock can be traced to simple employee execution, or the bank's policies and procedures. Last year, the group decided to increase branch hours by as much as 35% at some Manhattan locations in response to customer feedback.

The Tuesday meetings are bound get more interesting this year as Citi upgrades more branches with deposit-image ATMs and unveils new iPhone and Android applications for remote check deposit.

A more digital approach "helps us eliminate some of the cost in the back offices, because you don't have to deal with as much paper," Dinsmore said. "But you always have to be monitoring and looking at the risks involved with any type of digital solution. That's very much why we're doing these things in a phased rollout."

Of course, the ability to deposit checks without an envelope or even without visiting a branch or ATM is a small consolation to customers who are still grappling with the severest consequences of the credit crisis. Nightmarish stories about bungled home-loan modifications and botched foreclosure proceedings have reflected most poorly on the mortgage servicing industry, which was ill equipped to transition quickly to collections mode and to handle the rush of delinquencies and foreclosures.

"They were trying to address the problem but they weren't proactive enough, otherwise they would have had more people on deck at the time," said Cliff Rossi, a former chief risk officer for Countrywide Bank and, later, for consumer lending at Citi. Mortgage holders and investors also had trouble mobilizing, in part because second-lien holders had trouble tracking first liens, while first-lien holders could not tell when second liens existed. That data "should be available across a seamless process," Rossi said.

Now a teaching fellow at the University of Maryland's Robert H. Smith School of Business, Rossi remains hopeful that big players in the financial system eventually will reach their processing potential.

"This crisis pointed out so many deficiencies, from the front end to the back end," he said. "That said, I still think automation, the way in which we process, provides huge advantages to the customer. And if a lot of this stuff can be worked out, we'll all be better off."