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New world will need fresh IT thinking

While IT geeks herald what they call the cloud as the next big thing **John Murray** says technology and service providers are focussed on what needs to be done on Planet UK where shifting market and regulatory pressures are driving lenders to rethink their IT strategies

The buzz phrase among IT geeks is 'the cloud', which Wikipedia describes as a metaphor for the internet and an abstraction of the complex infrastructure it conceals.

Metaphors aside, the cloud allows us to access the world's processing power and databases using mobile phones, laptops or any network devices while all our computing needs, files and databases are effectively managed by third parties such as Google or Yahoo, or perhaps another Big e-Brother we have yet to hear about.

It's catching on among US consumers in a big way and could have business applications here. For example, a small building society could consign its processing and databases to the ether, with a couple of laptops and a BlackBerry at head office for access and control.

Initially this may be quite a cheap solution but given the reluctance of lenders to use terrestrial third party services and also the security risks involved it's unlikely that any lender will become an early adopter, or that the Financial Services Authority would countenance such a development.

So much for outsourcing to the sky, which puts offshoring to India into perspective. But here on Earth, if there is a common thread to this guide it is that mortgage lenders must respond to the changing market and rapidly evolving regulatory landscape, and that this response will inevitably involve investment in IT or using IT-based service providers – all at a time when margins are being squeezed.

The problem is that with business volumes down and increasing FSA pressure to strengthen balance sheets, the UK financial community is planning to spend less on IT this year than it did in 2008.

According to a Datamonitor report entitled *Impact Of Financial Crisis On Technology Spending In Banking* investment by this country's banking community in technology will decrease by almost 7% this year.

That's bad news in a sector in which some lenders are weighed down by legacy IT systems that would have inhibited their performance during the good times had they not taken on extra staff to manage the inflow of business.

Now, with volumes down, transaction costs will have soared. And as Frank Eve, managing director of Frank Eve Consulting, identifies in his article starting on page 22 of this guide, this raises questions about lenders' ability to integrate their systems with their intermediary partners and so achieve a more efficient and lower cost transaction model.

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Legacy systems create problems in the back office too where the challenge is managing collections and arrears with systems that are simply not up to the job.

True, lenders with legacy issues got round their front end problems when the market was hot by taking on extra processing staff but managing arrears in an era in which the mantra is treating customers fairly and protocols on repossessions have legal weight, reversing the concentration of activity from the front to the back end won't work, even with a bit of extra training.

The problem is that the world in which lenders operate has changed dramatically since the collapse of Northern Rock two years ago.

And it's not just that mortgage volumes and house prices are down and arrears and repossessions are up. Mortgage fraud is on the rise too, and in his article on technology's role in fighting fraud that starts on page 19 James Sherwood-Jones, managing director of Quest, quantifies the scale of the problem using figures from KPMG.

These show that the number of legal cases related to mortgage fraud have risen from 25 worth £36m in the whole of last year to 18 in the first half of 2009 already, with a combined value of £24m.

But he notes that these figures are the tip of the iceberg and only represent cases that have gone through the judicial system. Many instances of fraud go unreported or unnoticed and Sherwood-Rogers puts forward the argument that prevention is better than cure, maintaining there is a role for IT detecting such fraud at the application stage.

Of course, fraudsters are not the only criminals active in the business – there are rogue IT personnel within firms playing dodgy games too.

According to another Datamonitor report entitled *Using Technology To Combat Financial Crime In Retail Banking* the risks faced by banks are no longer limited to theft or money laundering but now include crimes such as data theft and financial misreporting.

But here, some experts believe, risk monitoring technology should not be regarded as a standalone solution. They say there is a need for compliance, fraud and security departments to work together on the issue.

There are also regulatory drivers of change. The Treasury paper entitled *Reforming Financial Services*, published on July 8, has plenty to say about due diligence and risk. For example, it states that financial institutions rely too much on data from the recent past as an indicator of future market performance ▶

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▶ and thereby dramatically underestimate the likelihood of relatively low-possibility events such as those of the past 18 months.

"Investors in structured products frequently failed to carry out sufficient due diligence and relied too much on credit rating agency assessments," the paper states. "Greater standardisation should facilitate investors carrying out more effective due diligence."

On the agenda are tough qualitative requirements on investor due diligence and originator transparency.

"These requirements will, from 2011, ensure investor credit institutions must demonstrate that they have understood and implemented formal policies and procedures for analysing and recording, among other things, the level of retention by originators, the risk characteristics of the securitisation position and underlying exposures," the paper adds.

Investors will also be required to establish formal policies and procedures for monitoring the performance of the exposures underlying their securitisations. In turn, originators will be required to apply the same standards to securitised exposures as those held on their own books.

All this represents a challenge which third party mortgage servicing companies and due diligence specialists such as HML and Exact should relish.

Moving on to retail customer issues the Treasury paper proposes the need for deposit-takers to have a single view of their customers. By that, the Treasury means an aggregated view of individual customer's accounts so that in the event of a payout under the Financial Services Compensation Scheme they can be compensated promptly.

Moreover, the paper emphasises that the introduction of that single customer view will be mandatory "to ensure that institutions provide a reliable and consistent picture of a customer's aggregate position with an institution".

The Treasury wants to see simpler eligibility criteria for claimants, improved communication over compensation arrangements with bank customers and measures to provide protection for balances temporarily above the deposit compensation limit. All this could be a tough call for traditional players with legacy issues.

While considering drivers of change, the Treasury paper also outlines the government's interest in the idea of mutuals sharing their back office facilities. This is an approach that has been tried in mainland Europe but despite the best efforts of service providers such as HML and Skipton's shared services subsidiary Mutual One the idea has failed to excite the collective imagination of the building society sector in this country.

The relevant paragraphs can be found in Chapter 9 of the paper.

"Across much of the rest of Europe there are shared operating models in the mutuals sector, notably in France, Germany, the Netherlands and Spain," it states. "Although there are a variety of such models typical features include the sharing of treasury services, back office functions and cross-guarantees with varying degrees of integration."

Although the Treasury says the impetus for structural reform must come from the mutual sector it is interested in exploring the potential of these models for UK mutuals.

The Treasury says it will confirm at the pre-Budget report stage whether or not any of the continental models could achieve economies of scale in the UK society sector. If so, it says it will identify barriers to moving towards shared operating functions while recognising the characteristics of the mutual sector in this country.

The structure of the sector which, with assets of around £240bn represents 20% of the UK mortgage market, could create problems. It is dominated by Nationwide which is bigger than the other 52 mutuals put together.

As of April this year Nationwide had

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group assets of £180bn. On December 31 2008 its next largest rival society, the Yorkshire , had assets of £23bn.

As the Treasury paper acknowledges, after Nationwide there are a few medium-sized mutuals and a large number of small independent societies. Nor are mutuals as homogeneous as one might think.

"Some societies have diversified in recent years and now offer a wide range of financial products and services including current accounts, credit cards, ATMs, travel money, unsecured loans, insurance and estate agency services," the paper notes.

Of course, there are no legal barriers to societies sharing back office facilities and a number have subsidiaries competing in that market.

The Yorkshire has a wholly-owned subsidiary called Yorkshire Key Services which was established in 2001 to provide core systems solutions and administration services to third parties.

In 2008 the product range was extended to include a savings affinity proposition and an outsourced, managed retail deposit administration service for firms seeking to raise substantial levels of retail deposits.

But despite being regarded as one of the most ethical players in the market it has not been inundated with contracts to share its expertise.

Skipton, currently ranked fifth in the league of UK societies with group assets of £13.6bn last December, owns HML which is the largest third party mortgage servicer in the country, with around £50bn assets under management.

It has a number of society clients but most of its work is focussed on managing mortgage books that societies have bought from other providers, although in response to the changing market it is now offering specialist servicing on on-balance sheet mortgages too.

Newcastle is the ninth largest building society in the country, with assets of £5.1bn as of December 2008. It has a subsidiary called Strategic Solutions which provides IT systems for the Shepshed, Stafford Railway and Melton Mowbray societies.

It also operates a saving management service which involves the provision of services for internet and telephone-based savings accounts whereby it looks after customer management, the administration of accounts and the transfer of funds. Pre-paid cards are the latest addition to its portfolio.

And then there's Kent Reliance – the 13th largest building society in the UK with assets of £2.3bn and an offshore subsidiary called Easiprocess in Bangalore, India. This offers back office and call centre services to the society while its outside clients have included Jamaica Building Society, an Islamic financial services company called Cordoba and a legal specialist.

Despite the fact that Easiprocess has allowed Kent Reliance to achieve the second-lowest management expenses ratio in the business – 0.4 compared with Coventry's 0.36 – it has similarly not been inundated by contracts with other societies feeling the need to control their costs more effectively.

A significant part of the problem for Kent Reliance is the sector's reluctance to move jobs offshore, especially when so many small societies are the backbone of their communities.

This issue could become an obstacle to the Treasury's federal solution for the society sector which would in all probability result in local jobs going elsewhere, although not abroad.

All four of these players have come up against a culture of independence and a reluctance to consign business and reputation to others so it seems unlikely that we will see the shared services model get off the ground.

But even if this happens in the UK it won't be on the same scale as in mainland Europe where mutuals tend to operate on federal lines rather than as independent businesses. ●

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