IJMRSETM

e-ISSN: 2395 - 7639

INTERNATIONAL JOURNAL OF MULTIDISCIPLINARY RESEARCH

IN SCIENCE, ENGINEERING, TECHNOLOGY AND MANAGEMENT

Volume 10, Issue 6, June 2023

INTERNATIONAL STANDARD SERIAL NUMBER INDIA

Impact Factor: 7.580

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International Journal of Multidisciplinary Research in Science, Engineering, Technology & Management (IJMRSETM)

| ISSN: 2395-7639 | www.ijmrsetm.com | Impact Factor: 7.580| A Monthly Double-Blind Peer Reviewed Journal |

| Volume 10, Issue 6, June 2023 |

New Challenges in Banking Industry

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ABSTRACT: The environment in which the banking industry operates has changed, mainly as a consequence of three developments: technological disruption, the more demanding regulatory framework and increasing competition from non-banks in some market segments. All those developments have implications for the sustainability of the business model of many commercial banks and have increased risks in areas including deposit stability, operational resilience and the exposure to complex leveraged institutions. Generalised changes in the risk profile of financial institutions mean a reflection on possible adjustments to the current regulatory framework is welcome. However, a significantly tighter regulatory stance might not necessarily be the most effective tool to address banks' all new vulnerabilities and may have undesired effects on their intermediation business. By contrast, there is large scope to strengthen supervisory practices to make them more intrusive and risk-sensitive.

KEYWORDS-New, Challenges, Banking, Industry, Technology, Competition

I.INTRODUCTION

The emergence of FinTech/non-bank startups is changing the competitive landscape in financial services, forcing traditional institutions to rethink the way they do business. As data breaches become prevalent and privacy concerns intensify, regulatory and compliance requirements become more restrictive as a result. And, if all of that wasn't enough, customer demands are evolving as consumers seek round-the-clock personalized service.

These and other banking industry challenges can be resolved by the very technology that's caused this disruption, but the transition from legacy systems to innovative solutions hasn't always been an easy one. That said, banks and credit unions need to embrace digital transformation if they wish to not only survive but thrive in the current landscape.[1,2,3]

1. Increasing Competition

The threat posed by FinTechs, which typically target some of the most profitable areas in financial services, is significant. Goldman Sachs predicted that these startups would account for upwards of $4.7 trillion in annual revenue being diverted from traditional financial services companies.

These new industry entrants are forcing many financial institutions to seek partnerships and/or acquisition opportunities as a stop-gap measure; in fact, Goldman Sachs, themselves, recently made headlines for heavily investing in FinTech. In order to maintain a competitive edge, traditional banks and credit unions must learn from FinTechs, which owe their success to providing a simplified and intuitive customer experience.

2. A Cultural Shift

From artificial intelligence (AI)-enabled wearables that monitor the wearer's health to smart thermostats that enable you to adjust heating settings from internet-connected devices, technology has become ingrained in our culture — and this extends to the banking industry.

In the digital world, there's no room for manual processes and systems. Banks and credit unions need to think of technology-based resolutions to banking industry challenges. Therefore, it's important that financial institutions promote a culture of innovation, in which technology is leveraged to optimize existing processes and procedures for maximum efficiency. This cultural shift toward a technology-first attitude is reflective of the larger industry-wide acceptance of digital transformation.

3. Regulatory Compliance

Regulatory compliance has become one of the most significant banking industry challenges as a direct result of the dramatic increase in regulatory fees relative to earnings and credit losses since the 2008 financial crisis. From Basel's risk-weighted capital requirements to the Dodd-Frank Act, and from the Financial Account Standards Board's Current Expected Credit Loss (CECL) to the Allowance for Loan and Lease Losses (ALLL), there are a growing number of regulations that banks and credit unions must comply with; compliance can significantly strain resources and is often dependent on the ability to correlate data from disparate sources.

Major Banking Regulations

Basel III	Published in 2009, Basel III is a regulatory framework for banks established by the Basel Committee on Banking Supervision. Basel III's risk-weighted capital requirements dictate the minimum capital adequacy ratio that banks must maintain.
Dodd-Frank Act	Passed during the Obama administration, the Dodd-Frank Wall Street Reform and Consumer Protection Act placed regulations on the financial services industry and created programs to prevent predatory lending.
CECL	Created by the Financial Accounting Standards Board, the CECL is an accounting standard that requires all institutions that issue a credit to estimate expected losses over the remaining life of the loan, rather than incurred losses.
ALLL	The ALLL is a reserve that financial institutions establish based on the estimated credit risk within their assets.

Faced with severe consequences for non-compliance, banks have incurred additional cost and risk (without a proportional enhancement to risk mitigation) in order to stay up to date on the latest regulatory changes and to implement the controls necessary to satisfy those requirements. Overcoming regulatory compliance challenges requires banks and credit unions to foster a culture of compliance within the organization, as well as implement formal compliance structures and systems.

Technology is a critical component in creating this culture of compliance. Technology that collects and mines data, performs in-depth data analysis, and provides insightful reporting is especially valuable for identifying and minimizing compliance risk. In addition, technology can help standardize processes, ensure procedures are followed correctly and consistently, and enables organizations to keep up with new regulatory/industry policy changes.[4,5,6]

4. Changing Business Models

The cost associated with compliance management is just one of many banking industry challenges forcing financial institutions to change the way they do business. The increasing cost of capital combined with sustained low-interest rates, decreasing return on equity, and decreased proprietary trading are all putting pressure on traditional sources of banking profitability. In spite of this, shareholder expectations remain unchanged.

This culmination of factors has led many institutions to create new competitive service offerings, rationalize business lines, and seek sustainable improvements in operational efficiencies to maintain profitability. Failure to adapt to changing demands is not an option; therefore, financial institutions must be structured for agility and be prepared to pivot when necessary.

5. Rising Expectations

Today's consumer is smarter, savvier, and more informed than ever before and expects a high degree of personalization and convenience out of their banking experience. Changing customer demographics play a major role in these heightened expectations: With each new generation of banking customers comes a more innate understanding of technology and, as a result, an increased expectation of digitized experiences.

Millennials have led the charge to digitization, with five out of six reporting that they prefer to interact with brands via social media; when surveyed, millennials were also found to make up the largest percentage of mobile banking users, at 47%. Based on this trend, banks can expect future generations, starting with Gen Z, to be even more invested in omnichannel banking and attuned to technology. By comparison, Baby Boomers and older members of Gen X typically value human interaction and prefer to visit physical branch locations.

This presents banks and credit unions with a unique challenge: How can they satisfy older generations and younger generations of banking customers at the same time? The answer to this banking industry challenge is a hybrid banking model that integrates digital experiences into traditional bank branches. Imagine, if you will, a physical branch with a self-service station that displays the most cutting-edge smart devices, which customers can use to access their bank's knowledge base. Should a customer require additional assistance, they can use one of these devices to schedule an appointment with one of the branch's financial advisors; during the appointment, the advisor will answer any of the customer's questions, as well as set them up with a mobile AI assistant that can provide them with additional recommendations based on their behavior. It might sound too good to be true, but the branch of the future already exists, and it's helping banks and credit unions meet and exceed rising customer expectations.

Investor expectations must be accounted for, as well. Annual profits are a major concern — after all, stakeholders need to know that they'll receive a return on their investment or equity and, in order for that to happen, banks need to actually turn a profit. This ties back into customer expectations because, in an increasingly constituent-centric world, satisfied customers are the key to sustained business success — so, the happier your customers are, the happier your investors will be.[7,8,9]

II.DISCUSSION

6. Customer Retention

Financial services customers expect personalized and meaningful experiences through simple and intuitive interfaces on any device, anywhere, and at any time. Although customer experience can be hard to quantify, customer turnover is tangible and customer loyalty is quickly becoming an endangered concept. Customer loyalty is a product of rich client relationships that begin with knowing the customer and their expectations, as well as implementing an ongoing client-centric approach.

In an Accenture Financial Services global study of nearly 33,000 banking customers spanning 18 markets, 49% of respondents indicated that customer service drives loyalty. By knowing the customer and engaging with them accordingly, financial institutions can optimize interactions that result in increased customer satisfaction and wallet share, and a subsequent decrease in customer churn

Bots are one new tool financial organizations can use to deliver superior customer service. Bots are a helpful way to increase customer engagement without incurring additional costs, and studies show that the majority of consumers prefer virtual assistance for timely issue resolution. As the first line of customer interaction, bots can engage customers naturally, conversationally, and contextually, thereby improving resolution time and customer satisfaction. Using sentiment analysis, bots are also able to gather information through dialogue, while understanding context through the recognition of emotional cues. With this information, they can quickly evaluate, escalate, and route complex issues to humans for resolution.

7. Outdated Mobile Experiences

These days, every bank or credit union has its own branded mobile application — however, just because an organization has a mobile banking strategy doesn't mean that it's being leveraged as effectively as possible. A bank's mobile experience needs to be fast, easy to use, fully-featured (think live chat, voice-enabled digital assistance, and the like), secure, and regularly updated in order to keep customers satisfied. Some banks have even started to reimagine what a banking app could be by introducing mobile payment functionality that enables customers to treat their smartphones like secure digital wallets and instantly transfer money to family and friends.

8. Security Breaches

With a series of high-profile breaches over the past few years, security is one of the leading banking industry challenges, as well as a major concern for bank and credit union customers. Financial institutions must invest in the latest technology-driven security measures to keep sensitive customers safe, such as:

- Address Verification Service (AVS): AVS "checks the billing address submitted by the card user with the cardholder's billing address on record at the issuing bank" in order to identify suspicious transactions and prevent fraudulent activity.
- End-to-End Encryption (E2EE): E2EE "is a method of secure communication that prevents third-parties from accessing data while it's transferred from one end system or device to another." E2EE uses cryptographic keys, which are stored at each endpoint, to encrypt and decrypt private messages. Banks and credit unions can use E2EE to secure mobile transactions and other online payments so that funds are securely transferred from one account to another, or from a customer to a retailer.
- Authentication:
- Biometric authentication "is a security process that relies on the unique biological characteristics of an individual to verify that he is who he says he is. Biometric authentication systems compare a biometric data capture to stored, confirmed authentic data in a database." Common forms of biometric authentication include voice and facial recognition and iris and fingerprint scans. Banks and credit unions can use biometric authentication in place of PINs, as it's more difficult to replicate and, therefore, more secure.[10,11,12]
- Location-based authentication (sometimes referred to as geolocation identification) "is a special procedure to prove an individual's identity and authenticity on appearance simply by detecting its presence at a distinct location." Banks can use location-based authentication in conjunction with mobile banking to prevent fraud by either sending out a push notification to a customer's mobile device authorizing a transaction, or by triangulating the customer's location to determine whether they're in the same location in which the transaction is taking place.
- Out-of-band authentication (OOBA) refers to "a process where authentication requires two different signals from two different networks or channels… [By] using two different channels, authentication systems can guard against fraudulent users that may only have access to one of these channels." Banks can use OOBA to generate a one-time security code, which the customer receives via automated voice call, SMS text message, or email; the customer then enters that security code to access their account, thereby verifying their identity.
- Risk-based authentication (RBA) — also known as adaptive authentication or step-up authentication — "is a method of applying varying levels of stringency to authentication processes based on the likelihood that access to a given system could result in its being compromised." RBA enables banks and credit unions to tailor their security measures to the risk level of each customer transaction.

9. Antiquated Applications

According to the 2017 Gartner CIO Survey, over 50% of financial services CIOs believe that a greater portion of business will come through digital channels, and digital initiatives will generate more revenue and value.

However, organizations using antiquated business management applications or siloed systems will be unable to keep up with this increasingly digital-first world. Without a solid, forward-thinking technological foundation, organizations will miss out on critical business evolution. In other words, digital transformation is not just a good idea — it's become imperative for survival.

While technologies such as blockchain may still be too immature to realize significant returns from their implementation in the near future, technologies like cloud computing, AI, and bots all offer significant advantages for institutions looking to reduce costs while improving customer satisfaction and growing wallet share.

Cloud computing via software as a service and platform as a service solutions enable firms previously burdened with disparate legacy systems to simplify and standardize IT estates. In doing so, banks and credit unions are able to reduce costs and improve data analytics, all while leveraging leading-edge technologies. AI offers a significant competitive advantage by providing deep insights into customer behaviors and needs, giving financial institutions the ability to sell the right product at the right time to the right customer. Additionally, AI can provide key organizational insights required to identify operational opportunities and maintain agility.

10. Continuous Innovation

Sustainable success in business requires insight, agility, rich client relationships, and continuous innovation. Benchmarking effective practices throughout the industry can provide valuable insight, helping banks and credit unions stay competitive. However, benchmarking alone only enables institutions to keep up with the pack — it rarely leads to innovation. As the cliché goes, businesses must benchmark to survive, but innovate to thrive; innovation is a key differentiator that separates the wheat from the chaff.

Innovation stems from insights, and insights are discovered through customer interactions and continuous organizational analysis. Insights without action, however, are impotent — it's vital that financial institutions be prepared to pivot when necessary to address market demands while improving upon the customer experience.

Financial service organizations leveraging the latest business technology, particularly around cloud applications, have a key advantage in the digital transformation race: They can innovate faster. The power of cloud technology is its agility and scalability. Without system hardware limiting flexibility, cloud technology enables systems to evolve along with your business.

How Hitachi Solutions Can Help

With so many banking industry challenges to contend with, charting a clear path forward can seem like an overwhelming task — but with the right team to support your efforts, digital transformation is attainable. The financial services team at Hitachi Solutions has been helping banks and credit unions unlock digital experiences through the power of the Microsoft platform since 2004. With a wide variety of products and services tailored to the financial services industry, such as Engage for Banking and Retail Banking Sales Insights, we're familiar with the unique issues financial institutions face and have developed the technology to resolve them.

From data science expertise to business intelligence, AI, and beyond, Hitachi Solutions is here to help your organization tackle banking industry challenges and embrace digital transformation.[13,14]

III.RESULTS

From cybersecurity crises to potential mergers that would reshape the payments industry, the banking world is poised for a year of change and regulatory challenges.

A major shake-up in the payments world is underway with Capital One Financial's recent agreement to buy Discover Financial for $35.3 billion, or a 26.6% premium based on Discover's Feb. 16 closing price. The all-stock deal, announced in February, would create a credit card behemoth with its own payments network.

"Our acquisition of Discover is a singular opportunity to bring together two very successful companies with complementary capabilities and franchises, and to build a payments network that can compete with the largest payments networks and payments companies," Capital One CEO Richard Fairbank said in a news release.

If combined, the two companies would have a 19% share of the $1.3 trillion market in revolving consumer loans, according to Brian Foran, an analyst at Autonomous Research. JPMorgan Chase is currently No. 1 with a 16% market share.

The two companies expect the deal to close in late 2022 or early 2025, pending approvals from regulators and both companies' shareholders. Three Discover board members, who will be named later, would join Capital One's board as part of the deal.

In the world of cybersecurity, a recent data breach at Infosys McCamish impacted more than 57,000 Bank of America customer accounts. The breach occurred on Nov. 3 — yet was not reported until 90 days after the incident on Feb. 2, raising concerns not only about why there was such a long delay, but also over who should take responsibility.

The unauthorized party — a ransomware group known as LockBit — accessed the name, address, date of birth, Social Security number and other account information of deferred compensation customers through Infosys McCamish's system, not Bank of America's, according to a letter Infosys McCamish sent to affected customers that was published by Maine's attorney general.

Many organizations require vendors to go through mandatory security audits to maintain a chain of trust, said Ray Kelly, a fellow at Synopsys Software Integrity Group, but the case still reflects poorly on Bank of America. In this instance, Infosys McCamish "certainly bears the weight of this breach," Kelly said, as its systems were attacked by the ransomware.

Regulators, however, take a different view of this type of third-party cybersecurity risk. Banks are responsible, according to the Federal Reserve's vice chair for supervision, Michael Barr, who said in January that banks need to fill the "gaps" in their efforts to manage these risks.

In Washington, D.C., the future of the Basel III endgame proposal remains uncertain after Treasury Secretary Janet Yellen declined to take a position on the contentious regulatory plan that would raise capital standards for the largest banks.

In lively discussions during a House Financial Services Committee hearing in February, lawmakers on both sides of the aisle were critical of the proposal. Rep. Bill Huizenga, R-Mich., chairman of the House Financial Services oversight subcommittee, pressed Yellen on her decision to avoid commenting on the specifics of Basel. In reply, Yellen said that she gives her thoughts on a regular basis to the heads of the Federal Deposit Insurance Corp., Office of the Comptroller of the Currency and the Fed. She said that she hasn't had a meeting with President Biden on the topic.

Commercial lending: NYCB strife with rent-regulated loans causes investors concern

Banks have been making rent-regulated apartment loans for decades, but the confluence of watershed legislation in 2019, rising interest rates and inflation has made it more difficult for landlords and property managers to turn a profit, according to Wedbush Securities analyst David Chiaverini.

New York Community Bancorp's concentration in the sector makes it an outlier among regional banks. Roughly one-fifth of all loans held by the Long Island-based bank are exposed to the New York rent-regulated multifamily market. This has contributed to the bank's recent struggles and put investors on high alert about the rapidly declining value of rent-regulated apartment loans in New York City.[15,16,17]

New York Community built its business with landlords and property owners in the rent-regulated sector over the course of decades. But challenges, including an unexpected dividend cut and a poor fourth-quarter earnings report that included a large loss provision, have intensified scrutiny of the bank's vulnerability to weaknesses in the commercial real estate market.

Succession planning: Will TD's beleaguered CEO be pushed or jump?

A "series of missteps," including possible federal anti-money-laundering violations and the cancellation last year of TD's planned acquisition of First Horizon, could put pressure on TD Bank Group CEO Bharat Masrani to step down sooner rather than later, said a recent Jefferies analyst note, written by John Aiken, John Ng and Aria Samarzadeh.

Mike Rizvanovic, an analyst at Keefe, Bruyette & Woods, told American Banker Staff Writer Catherine Leffert that he thinks Masrani will stay at the helm of the $1.96 trillion company at least until the dust has settled on the Justice Department's anti-money-laundering investigation so that the next leader can start with "a clean slate." He said the board and shareholders would prefer if current management saw the company's issues through.

Rizvanovic says there's been a lack of transparency from the bank regarding the investigation, which has fueled "angst" from investors. "He's definitely toward the later innings of his tenure," he said. "It'd be tough for him to leave in the midst of what a lot of investors are very concerned about right now."

Credit cards: Capital One-Discover merger aims to shake off underdog status

A proposed merger between Capital One Financial and Discover Financial Services, two of the six-largest U.S. card issuers, requires approval from federal regulators and is likely to invite heavy regulatory scrutiny. The companies, however, say the deal would help the Discover payments network compete against larger rivals such as Visa and Mastercard.

In a joint announcement in February, the two companies portrayed Discover as a relative underdog, even as it has built a "rare and valuable global payments network" that's accepted at 70 million merchants in more than 200 countries and territories. Despite its growth, Discover is "the smallest of the four U.S.-based global payments networks," the companies said.

Analysts had mixed reactions amid news reports that the deal was coming to fruition. The benefits of gaining its own payments network "could perhaps justify" paying a sizable premium for Discover, according to Brian Foran, an analyst at Autonomous Research. But a Capital One-Discover merger would combine two major players in the credit card market, which may raise competitive questions for regulators, Foran wrote in a note to clients.[18,19]

Data breaches: Is responsibility a gray area or black and white?

A data breach last November at the financial software provider Infosys McCamish by a ransomware group known as LockBit compromised the name, address, date of birth, Social Security number and other account information of 57,028 deferred compensation customers whose accounts were serviced by Bank of America.

"Reliance by banks on third-party service providers has grown considerably in recent years, and with that reliance comes the potential for greater cyber risk," Michael Barr, the Federal Reserve's vice chair for supervision, said earlier this year. "It is ultimately the responsibility of banks to manage their third-party risk."

IV.CONCLUSION

Politics and policy: Yellen defers to bank regulators on Basel III proposal

Treasury Secretary Janet Yellen told several lawmakers during testimony before the House Financial Services Committee in February that she would leave the fate of the Basel III endgame proposal to the bank regulators, amid an intense lobbying campaign from the country's largest banks and bipartisan pushback against the rule.

The Basel proposal would raise capital standards for the largest banks and has been the target of TV advertisements, many public letters from lawmakers and even veiled threats of a lawsuit as banks fight against the rulemaking.

"I'm not going to take a position on the details with the rule," she said.

Lawmakers on both sides of the aisle criticized the proposal during the hearing. In response to Rep. David Scott, D-Ga., who expressed concerns about potential small-business and consumer lending impacts of the proposal, Yellen said she believes it's important that the country has a strong banking system with adequate capital, but she qualified that by acknowledging the nature of the largest criticisms against the proposal.

Consumer banking: Soaring betting epidemic has banks on alert

Over the last six years, legal gambling has spread like wildfire across the United States. In early 2018, before a pivotal U.S. Supreme Court decision, only Nevada allowed sports wagering. Now 37 states do, plus the District of Columbia. State lawmakers have moved quickly amid fears that standing pat will result in a loss of tax revenue as their residents gamble in neighboring states.

Gambling is a growing source of revenue for banks. "The opportunities for them are overshadowing the risks and dangers," Brianne Doura-Schawohl, a lobbyist who advocates for policy responses to problem gambling, told Kevin Wack, national editor at American Banker.

But judging by the experiences of the United Kingdom, which has a longer history of widespread legal gambling than the United States, banks here may eventually be dragged into the burgeoning debate over how to address problem gambling. After all, banks provide credit to bettors who have already depleted their savings. Banks are also well positioned to offer ways to make it easier for problem gamblers to protect themselves from their own self-destructive impulses. And banks hold reams of transaction data that can indicate which customers have gambling problems.

Regulation and compliance: Fintechs rethink their banking-as-a-service partnerships

A recent analysis by S&P Global Market Intelligence found that banks that provide banking as a service to fintech partners accounted for 13.5% of severe enforcement actions issued by federal bank regulators in 2022, a disproportionately large number considering how few banks in the U.S. engage in BaaS, the analysis said.

A fintech or other company tied to a bank experiencing a regulatory crackdown may be limited in the products it can launch or modify, or face increased scrutiny from new banking partners if they wish to jump ship. Even entities that have not run into trouble may experience ripple effects in the BaaS space. This is causing a shift in how fintechs view their banking-as-a-service relationships and how they should position themselves moving forward.

"As recently as two years ago, it was common practice to figure out the path of least resistance for a fintech-bank sponsor relationship," Clayton Mitchell, principal at consulting firm Crowe, told Miriam Cross, tech reporter at American Banker. "That mindset has changed over the last 18 to 24 months. Fintechs are looking for business partners who are in banking-as-a-service genuinely and strategically. That means the due diligence is likely harder."[20]

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