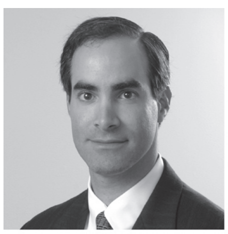
AMERICAN BANKER®
THE FINANCIAL SERVICES DAILY

Friday, December 18, 2009

VIEWPOINTS

Tighter Regulation Blocks Old Paths to Profit



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Banks have spent a long, turbulent spell wrestling with huge credit and liquidity challenges. They have skirted insolvency, survived vertiginous drops in asset prices, raised fresh capital and adapted to tougher government oversight. Much more work remains to be done.

Despite some recent improvement, banks' structural profit pools have shifted, with little sign that they will soon return to precrisis levels on a sustained basis. Profits of U.S. banks tumbled from a peak of $230 billion in 2006 to a $39 billion loss in 2008. Powered by near-record low interest rates and a favorable trading environment, banks swung to a $28 billion profit through mid-2009. But further losses loom in troubled real estate and commercial and credit card loans. An analysis by our firm calculates that the financial sector will earn at least $200 billion less than its cost of capital during the next five years.

A tougher regulatory landscape will close off pathways to restore earnings. Though specifics remain uncertain, lenders will almost surely face new disclosure rules, caps on fees and limits on securitization that will crimp profitability. They will also need to raise fresh capital — $200 billion on top of the $390 billion the big U.S. banks raised during the past year — which will reduce their returns on equity.

Climbing out of this hole will challenge banks to fundamentally retool three key elements of their businesses where they retain room to maneuver.

Customer loyalty is critical. How a recovery plays out, or affects any particular institution, will be determined by the changed behavior of customers and how nimbly banks respond. Bank customers' chief objectives will be to repair their battered household balance sheets by paying down debt and rebuilding cash reserves. But even as the savings rate rises (from just 1% in 2007 to about 7%, by our calculation), the net flow of household income into financial assets will be 20% lower on average through 2013 than during the flush years from 2004 to 2008. For this year, we estimate that total flows will plunge to $390 billion, from $800 billion in 2007.

Banks will need to take customer loyalty seriously. They have a lot of ground to make up to regain customers' trust. Using a measurement called Net Promoter Score, we have tracked trends in customer loyalty at scores of financial services companies over the past five years.

When we last surveyed customers of financial service providers in mid-2009, NPS for the sector overall had rebounded a bit from the all-time lows when the markets were cratering last fall. The findings also point to distinct pockets of opportunity for some institutions. Specifically, scores for regional banks have held up far better than those of the troubled big banks.

Cut complexity to contain costs. As revenues grew with economic expansion through 2007, banks felt little pressure to hold down operating expenses. They have a long way to go. They must reduce costs by $45 billion by 2012 to regain the returns on equity that prevailed in 2007.

Conventional approaches are apt to fall short, and banks will need to rethink their business models. Banks that succeed in tackling complexity begin by calculating what their cost structure would look like if they were to offer just one product. Then they cost out each new product variant as features are added back in. Companies that undertake this exercise typically find that costs do not rise linearly but rather jump sharply at break points where added complexity starts to strain against capacity.

Factor risk back into capital management. The fundamental blind spot at the heart of the financial meltdown has been an institutional failure to properly assess risks and put safeguards in place to control them. Poor risk management led banks to miscalculate their true profitability and, as a consequence, to commit scarce capital to developing and marketing the wrong products; they also adopted the wrong incentives to reward "success."

When measured on a risk-adjusted basis, the healthy-seeming accounting profits banks reported in recent years turned out to be vaporous.

Clearly, a more realistic approach to

appraising risk and managing capital should play a much more prominent role in today's more sober times. Restoring rigor and balance to risk management and capital allocation requires tackling the problem at its source — establishing clear, effective decision processes to weigh risk and deploy capital according to the bank's strategic objectives and longer-term efforts to increase shareholder value.

Effective decision-making integrates three key elements. It begins by spelling out the bank's overarching risk and capital strategy, setting clear guidelines for how risk should figure in line managers' decisions consistent with the bank's overall risk appetite. Second, it establishes clear governance rules to guide the strategy's implementation, assigning specific decision roles to ensure effective oversight with minimal bureaucracy. Finally, it aligns strategy and governance in the day-to-day decisions made by the bank's operating units, providing tools for monitoring the capital and risk position of each business unit.

Banks that respond to the painful shift in profit pools may not get the quick earnings kick the sector once enjoyed through leverage and by embracing risk. But they will surely earn a competitive edge.

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