# New rules of the road for banks

Overcoming the regulatory challenges to growth

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The raft of banking reforms enacted after the financial crisis are finally beginning to kick in, but many Western banks remain stuck in clean-up mode. Even banks that have made progress have been hesitant to lend aggressively, given the remaining ambiguities over key details in reforms, such as the Dodd-Frank Act in the US and the Basel III global capital standards. The new restrictions, coupled with the industry paralysis, have left returns on equity (ROEs) well below 2006 levels—and below the cost of equity in many instances (see Figure 1).

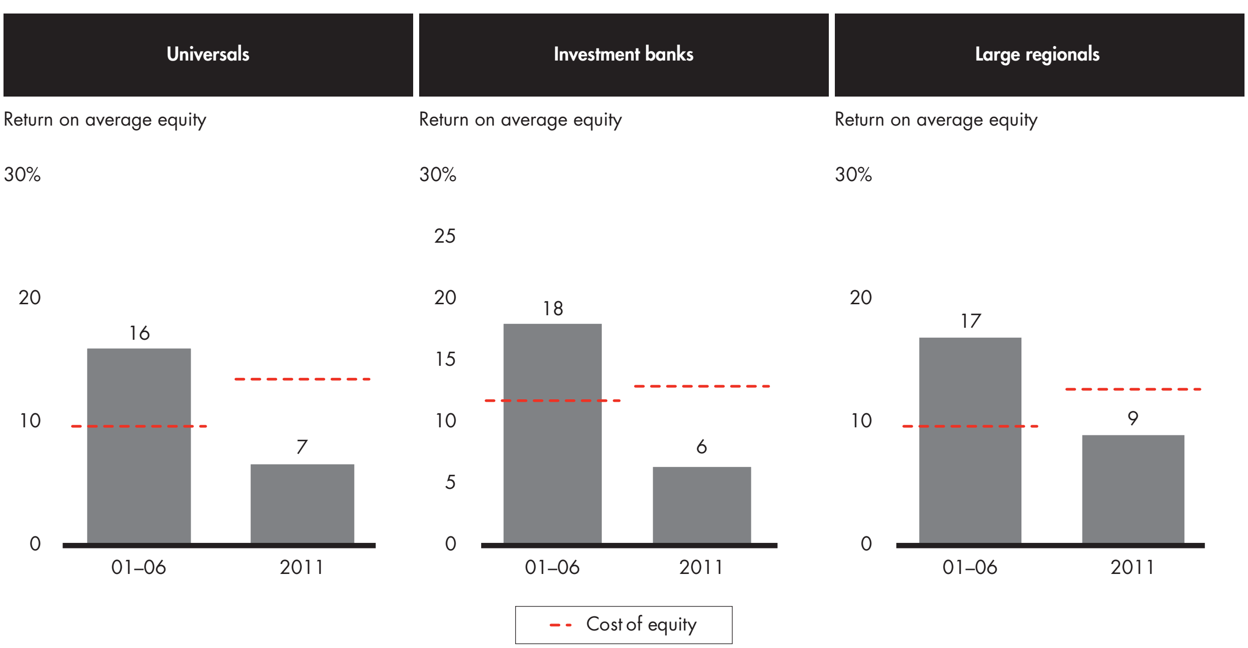
The next couple of years may offer more of the same. Uncertainty remains high and economic recovery weak—and in some markets, a distant hope. Monetary policy, still expansionary in most developed markets, has crimped net interest margins at many banks. Loan losses are elevated above pre-crisis norms in many markets (and are worsening in some European markets), and the system is still under stress. The great deleveraging of the financial system continues around the world—rapidly in the US, but painfully slowly in Europe.

This deleveraging is compounded by the aging populations in most Western countries. As populations age, loan demand naturally recedes.

More challenging is the regulatory backlash that is changing the fundamentals of banking. Tougher new capital regulations are increasing equity requirements and limiting the ability of banks to leverage their balance sheets. New liquidity ratios are constraining lending activity in some markets, while tougher funding ratios are changing the way banks manage their assets and liabilities. Regulators are placing limits on customer fees in many markets, and the compliance burden has increased significantly. The result is that balance sheets and income statements are hemmed in from all sides.

In the US, the Dodd-Frank reforms may place restrictions on what were some of the industry's most lucrative activities, limiting proprietary trading, forcing some derivatives onto exchanges and restricting consumer banking fee income. The Dodd-Frank reforms alone could reduce average ROEs at large universals and

*Figure 1:* While US bank profits have rebounded, return on equity is still not at pre-2006 levels and is lower than the cost of equity




Sources: SNL; Bloomberg

investment banks by two percentage points and at large regionals by a percentage point *(see Figure 2)*.

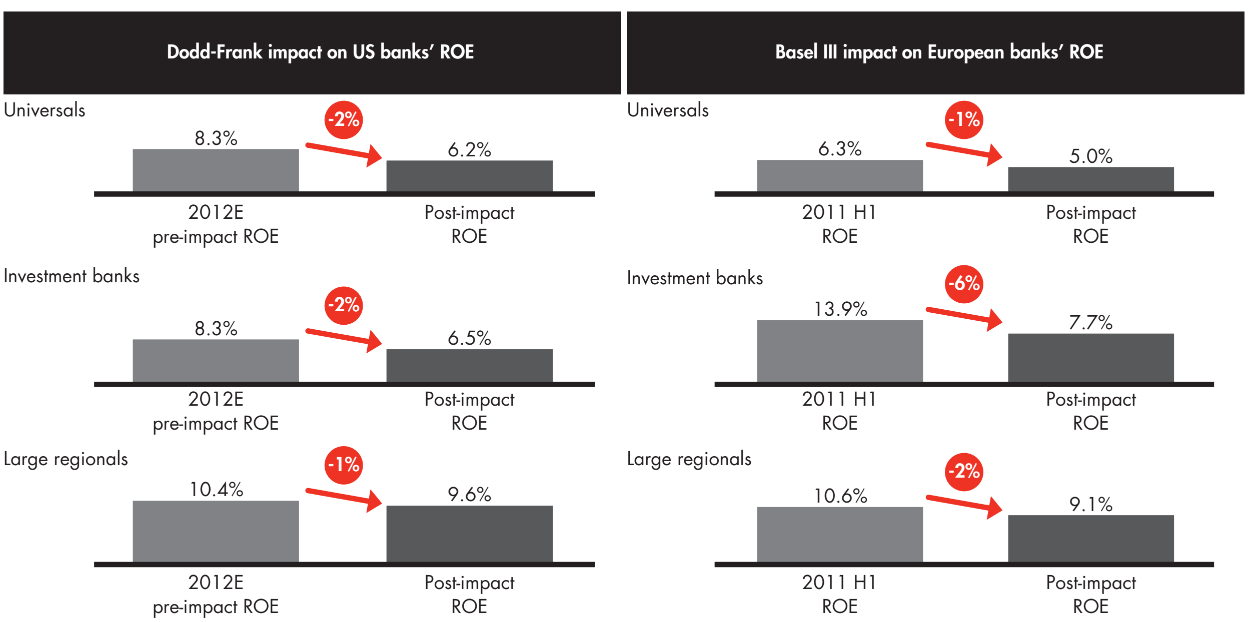
Globally, the new capital standards in the Basel III accord also will eat into industry returns. Higher Core Tier 1 requirements and more stringent risk-weighting will continue to reduce the industry's average ROE: We estimate that large European universals and retail banks will see ROEs reduced by between one and two percentage points, and for the investment banking and wealth-focused players, by six percentage points on average (before mitigating actions taken by these players).

And even though the new liquidity requirements in Basel III don't take full effect until 2019, they have begun to shape funding strategies. The looming liquidity requirements have contributed to a battle for funding among European banks, many of which are struggling in parallel to raise funds from skittish wholesale markets *(see Figure 3)*. The wall of refinancing that Europe faces—more than EUR1.8 trillion for major European countries and banks—is placing stress on net interest margins, which already are well below pre-crisis levels. It's no secret why bank profitability has taken a pounding.

These rulemaking and macroeconomic uncertainties have created huge strategic pressures on banks. To attract and retain shareholder capital, banks have to change their portfolio strategies, business models and ambitions. Many have already moved aggressively, but others remain cautious in the face of weak demand for the businesses or assets they'd like to sell and the ongoing balance sheet stresses created by the losses most banks incurred during the crisis.

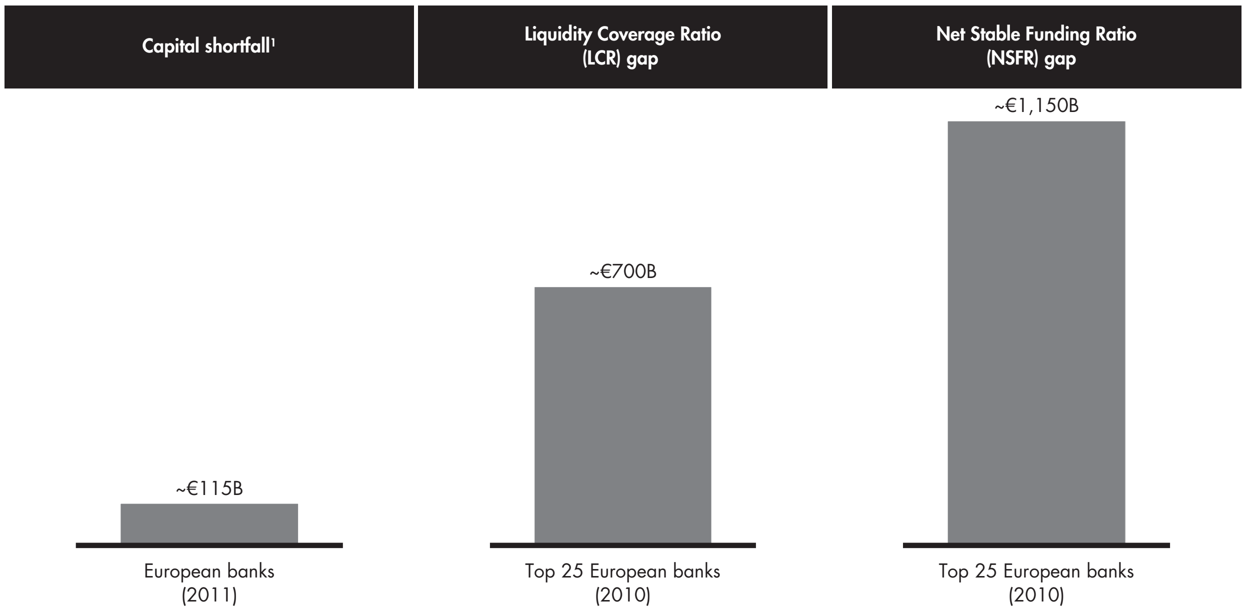
For bank CEOs, the questions are how—and how fast—to act and which moves to take to protect the franchise and establish future paths for profitable growth.

*Figure 2:* Regulatory impact on return on equity will be significant for both European and US financial institutions




Note: Before bank mitigation
Sources: Company filings; analyst reports; Bain analysis

Figure 3: European banks face capital and liquidity challenges




[1]To meet 9% Core Tier 1 ratio required by EAB for June 2012
Sources: EAB stress test findings; bank reports; analyst reports; Bain analysis

## The course ahead

Facing this tsunami of change, the industry will continue to evolve and restructure. This wave of change has some way to go. In our conversations in the industry and with our clients, many bank CEOs are focusing on three imperatives:

### 1. Strengthen the foundation

***Batten down the balance sheet.*** In the '90s, the industry focus moved away from sound capital management principles to generating heady revenue growth. Now those principles are relevant again.

Banks everywhere are triaging their balance sheets—deleveraging, changing their funding strategies and strengthening their capital structure. In the last year alone, regulatory pressures prompted several large banks—including Commerzbank, RBS, Bank of Ireland and Bank of America—to use debt-for-equity swaps to boost their core capital. For most banks, the Holy Grail remains a robust Tier 1 capital ratio, sustainable loan-to-deposit ratios and higher levels of liquidity (particularly in Europe).

While banks have made strides in shoring up their balance sheet, the actions to date have not been enough. At most banks, the cost of capital and operating liquidity remains well above pre-crisis levels at the same time that the productivity of these resources has declined. As a result, bank executives need to deploy capital and liquidity more selectively, which in turn requires new and more rigorous discipline.

This renewed strategic focus on the balance sheet has altered the debate around many executive tables. Many bank leaders tell us that they've turned their strategic and performance focus on its head—from a pre-crisis focus on revenues, costs and profits to a focus on the soundness and sustainability of the balance sheet. Leading banks have already installed new rigorous capital allocation approaches and revised their funds transfer pricing and liquidity deployment processes to favor the most profitable and valuable business and product lines. That has meant dusting off "value-based management" disciplines that focus on the strategic allocation of capital. Given the new regulatory mandates, these disciplines are back in fashion—and carry more bite.

Not only must future allocation strategies account for the full cost of capital, but also the full cost of liquidity. Bank executives long took liquidity for granted and often treated all sources and uses of liquidity essentially equally, but the crisis highlighted the need for new metrics. Risk-weighting and liquidity absorption rates need to be measured for each product and provided to every account manager to gauge the underlying health of their business.

Bank executives also need to adopt a more top-down approach to managing both their capital and liquidity. Instead of unleashing business units to maximize their own returns (often at great risk to the overall institution), bank leaders need to shape and constrain business unit strategies according to the overall needs of the group. For example, several US financial institutions, such as GE Capital and Capital One, that largely funded themselves in the wholesale markets have acquired large books of deposits through their direct banking arms as an alternative and more reliable source of funding—akin to what the finance arms of some European automakers, such as Volkswagen, BMW and Renault, have done to attract deposits. For many banks, top-down mandates have been issued to retail businesses to accelerate cross-selling strategies designed to tap more stable funding sources presented by existing customers.

***Get more out of the income statement.*** Strengthening the foundation also means lowering the cost of doing business. While many banks have announced cost-cutting programs, almost half of these savings will be negated by the growing expense of complying with the new regulations. And that doesn't include the one-time cost of setting up IT systems and establishing associated processes and procedures, which could run another $30 billion for US banks. Many banks will need to rethink their operating models, since the easiest back-office savings have been taken. Consumers' increasing preference for self-service through digital channels offers banks a chance to radically reduce their distribution costs.

Transforming the expense base will also require banks to implement more effective and efficient processes for managing customer relationships. That will require greater innovation from an industry known in most countries for its woeful service. To improve the experience for younger customers, banks will need to develop novel distribution strategies that take advantage of the latest technologies, such as mobile platforms and social media. That will offer a "win-win" by enabling banks to reduce their distribution costs, even as they provide customers with greater convenience. Banks also will need to reduce their operational complexity by simplifying their product range, which can further reduce the cost of serving customers.

Labor costs offer another opportunity for savings. Labor represents almost half of non-interest expenses for the average commercial bank, and significantly more at investment banks. The growth in retail bank compensation has outstripped that of the private sector in the US, with the result that industry wages at the end of 2011 were 1.6 times the national average, versus 1.4 times the average in 1991. With banks now facing the prospect of earning utility-like returns, labor costs have to fall. That can occur through leaner staffing, but banks must also better align pay to productivity. By holding employees accountable for the bank's performance over the long term rather than the short term, management can make sure that labor costs remain in sync with shareholder returns.

## 2. Become more flexible, agile and adaptable

Less visible, but more pernicious, is the slowdown in decision making and execution triggered by the unprecedented level of regulatory scrutiny and uncertainty. Banks are still figuring out how to run through the mud created by the new regulatory environment and cannot afford the kind of ponderous decision making that inhibits crisp action.

The need for banks to develop quicker reflexes is increasing across a broader—and more consequential—range of issues and geographies. Macroeconomic uncertainties, such as those surrounding Europe's debt crisis, are causing quick shifts in market and strategic expectations. The potential for Mideast conflict, European social unrest, Chinese bank stress and US fiscal upheaval means that banks must be ready to readjust their strategies and risk controls at any time.

While the imperative for rapid decision making has increased, bankers face far greater challenges today than before the financial crisis. Regulators are demanding greater clarity in decision making—and evidencing of due process. But stripping out layers of management to rein in costs has left many organizations unclear about how decisions should be made. Too often, CEOs and other senior bank leaders can be blinded by subordinates to the friction that exists at lower levels of the organization—and sit frustrated when decisions and action don't happen on time, or even at all.

In response to the increased uncertainty and scrutiny, many bank CEOs are now trying to improve their organization's capacity and capability to make decisions. A more robust and transparent approach to decision making—with defined decision roles, responsibilities and processes—will become a source of competitive advantage by enabling faster, better decisions and execution.

### 3. Cultivate new sources of sustainable growth

Every market contains pockets of opportunity. Some currently attractive opportunities include middle-market corporate lending in the US, small and medium enterprises (SMEs) in continental Europe and front-book mortgages (that is, mortgages for new customers) in the UK. Some banks are attempting to shift from capital-intensive activities, such as underwriting and structured finance, to transactional businesses that are less capital intensive, such as trading on behalf of customers in foreign exchange, equities or commodities.

But these strategies won't be enough to deliver robust growth. Forward-looking banks are now seeking growth by focusing on their greatest—and most neglected—asset: their customer relationships. Banks need to relearn how to attract, nurture and retain their customer relationships. That will necessitate changes in how they do business and require them to take action:

***Design customer-friendly banking products and services.*** The new mantra at many banks is "simplicity," which involves streamlining the product portfolio, eliminating hidden fees and adding simple, innovative products that serve customers better. Regaining customer trust will require banks to swear off what regulators have determined are "bad profits" by rooting out practices that undermine customer relationships.

Banks also need to look for creative ways to "reinvent" revenue through new service and pricing models—and to simplify their operating models in ways that build greater customer loyalty. Early attempts by some large banks to impose monthly fees on formerly free checking accounts met with fierce public and political opposition. Given that opposition, some banks are pursuing more innovative approaches. For example, at the beginning of 2011, 70% of PNC's new customers opted for a free checking account. Then, in March 2011, the bank introduced a new relationship account. By the fourth quarter of 2011, 60% of new PNC customers choose the relationship account.

***Organize distribution around the customer, not the transaction.*** US banks are thinning out their branch networks, raising the skills of their workforce and hiring more relationship managers—generalists and specialists alike. We see greater interest in micro-market practices that banks such as Santander, BNP Paribas and Westpac have used to retain customers and win more wallet share. These practices focus on the whole customer relationship by emphasizing local accountability, enhancing relationship models, improving sales and service and aligning the distribution footprint and format to customer needs. Most banks have a ways to go, as they remain focused on adding new—and sometimes marginal—customers, rather than becoming truly customer-centric.

But given that much of the current infrastructure is designed to process transactions, there's a mismatch between the industry's capabilities and what it will take to earn more business from clients. Distribution networks need to become better at managing relationships, even as the industry reduces headcounts and other costs. While still in the experimental stage, the advent of video ATMs shows the effort banks are making to build the human touch into self-service interactions at a lower cost.

***Develop compelling experiences that give customers a reason to give the bank more business.*** Some of the most promising opportunities lie with more affluent account holders and with the small and midsize business customers that generate the majority of a retail bank's profit. Both of these groups, however, are among banks' biggest critics. Converting them to "promoters" will require banks to develop innovative service models, product offerings and pricing strategies. Several cutting-edge banks in Europe and the US already are working to improve the customer value proposition by reengineering their critical service touchpoints. These banks are collecting insights about the customer experience and creating new products, services and forms of engagement to delight their customers. The calculation they're making is that the investment in a better customer experience will boost customer acquisition, retention and share of wallet over time—and spare banks from competing solely on price.

The trend toward digitization represents both a threat and an opportunity for banks attempting to develop compelling experiences for customers. While the shift from expansive branch networks to digital channels can generate significant savings, the associated drop in branch traffic may reduce the opportunities for selling new products and services face-to-face. Savvy banks are replacing these interactions at a faster rate than the competition, with more targeted and effective engagement over social, mobile and Web channels.

This is a time of strategic change for the banking industry. While regulators are reshaping the playing field for the industry fundamentally, CEOs need to forge new business models to deliver better services that cost less, focus more on the customer, depend less on leverage and provide a more balanced foundation for growth. This journey has only just begun.

## When the conventional wisdom no longer works

The new regulatory order and macroeconomic environment is changing everything from how bankers deploy capital and liquidity, how they manage their balance sheets, to where they seek growth. While regulators—and lobbyists—are still working on the final details that will determine how banks operate in the future, it is clear that much of the old conventional wisdom no longer holds.

**Conventional wisdom #1: Drive returns by maximizing leverage**

During the boom years, maximizing leverage was the name of the game in banking. Winning advanced internal ratings-based status from regulators and employing internal economic models helped banks reduce capital requirements, grow leverage and add a percentage point or two to their ROE. Banks put a lot of reliance on measures and models that, in hindsight, were poorly calibrated. They also instilled some other unwholesome habits:

- A reliance on short-term funding. For some institutions, this reliance on short-term funding created a greater mismatch on their balance sheet—and triggered a crisis when wholesale markets seized up. The new Net Stable Funding Ratio and other liquidity and funding requirements will render any overreliance on wholesale funding unprofitable.
- An unhealthy dependence on "maximum leverage," replaced by a new focus on "robust solvency." As a result, many banks now sport Core Tier 1 ratios that are about 1.5 times what they were before the crisis. Basel III virtually ensures this will be the case for years to come.
- Freely available—and cheap—internal capital and liquidity have been replaced by rationing. Banks now have a laser-like focus on their balance sheet.

**Conventional wisdom #2: Bigger is better**

In the run-up to the crisis, bankers single-mindedly pursued the presumed benefits of scale—acquiring, consolidating and extending their way across many borders. Now, the capital overlays that are a critical part of Basel III for financial institutions deemed "systemically important" have effectively imposed a tax on scale.

Indeed, ROEs have fallen close to—if not below—the cost of equity capital for many banks, given the combination of tighter margins, lower leverage and the new imperative to remain solvent. In the US, regulators have forced bigger banks to pay higher fees for deposit insurance by switching the assessment methodology to one based on assets rather than on deposits.

There's evidence that the new regulatory bias against bigness isn't temporary. In both the US and UK, political pressure is building to end the practice of bailing out institutions deemed "too big to fail." Richard Fisher, the president of the Federal Reserve Bank of Dallas, recommends "downsizing the behemoths over time into institutions that can be prudently managed and regulated across borders" in a Federal Reserve Bank of Dallas report. So bigger is no longer considered better, and some institutions such as Bank of America have eschewed acquisitions recently where the cost of complexity has outstripped any benefits from scale.

**Conventional wisdom #3: Diversification is always good**

Regulation has changed the benefits of diversification. There are few doubts that, in theory, diversification can reduce risk. But regulators and bankers have learned to no longer trust modeled correlation coefficients in a crisis—and to better understand the hidden risks of diversification.

In markets such as Ireland, banks expanded aggressively beyond their shores—ostensibly reducing risk through cross-geographic exposures that were considered less correlated. But too often, those banks funded diversification through international "hot deposits" such as wholesale funding. When the value of those presumably uncorrelated assets fell in lockstep, the hot money fled and governments were left holding the bag.

Other banks discovered that their blind pursuit of diversification led them to take on second-tier positions in markets—positions that locked them in to unattractive returns when the tide receded. For example, Swiss banks saw their investment banking positions unravel, while some European banks retreated from Eastern Europe. The lesson is that diversification still has benefits, but diversification without competitive strength no longer works.

**Conventional wisdom #4: Manage your "stars" from afar**

In the war for talent, bank leaders competed aggressively by creating a star culture and pay model that replaced oversight and leadership. The ethos was "hire the right people and get out of their way." Often, pay and rewards delivered hothouse growth and outsized short-term returns at the risk of supersized losses during the crisis.

Now, regulators and politicians are seeking new ways to impose controls on pay, such as deferred compensation and clawbacks. In many markets, including the UK and France, banks are facing regulatory and public pressure to reduce banker compensation.

With bank boards and regulators exerting more control, the balance of power has shifted inside many institutions. Compensation is down and management oversight has tightened, as regulators and compliance executives hold new sway.

That requires new disciplines of talent management. A generation of bankers that grew up in a more laissez-faire culture is chafing, and the fêted talent has begun migrating. Employment in banking in New York is down from the peak before the crisis. Shadow banking has been the beneficiary to date, with numerous high-profile defections from big investment banks to join or start hedge funds over the past three years.

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