

## Back to the Drawing Board for 2012

As banks gear up for 2012, the problem is not just overcapacity, but obsolete capacity. Deeper cost cuts must fit within a larger plan to rebuild the business, including assessments of future balance sheets. Decisions must be made regarding resource deployment, along with multi-year plans for implementation.

BY STEVE TURNER

With extended flat rates now a virtual certainty following the Fed's August 2011 announcement, all of banking's major profit levers are constricted going into next year. But it will take more than extreme cost reduction to meet the challenge.

Struggling with a weak economy and the regulatory effects of Dodd-Frank and Basel III, banks face a tremendous planning challenge, not just to slash overhead, but to reposition all of the major business lines for an uncertain future where few of the old rules apply.

For more than a year now, executives have been anticipating a rebound in interest rates. Swollen portfolios of cheap deposits could finally be invested in higher-yielding loans and investments, providing critical new streams of net interest income.

As that prospect is now gone, tough decisions can no longer be delayed. It is not just a problem of overcapacity, but of obsolete capacity. The checking business, for example, does not merely need to be economized following slashing of debit and overdraft

fees — it needs to be re-invented for a permanently changed market.

For executive management, one immediate priority is to comprehensively diagnose the unfolding revenue challenge. Some issues affect the entire organization; others have varying effects on individual lines of business.

It is a witches' brew of revenue challenges, including declines in debit and overdraft fees; tepid loan demand; slim margins; a dwindling trend of falling loan-loss provisions; and for the biggest banks, a bleak future for proprietary trading. Meanwhile there is a huge overhang of troubled residential loans.

Compounding the challenge are the new international banking regulations under Basel III. Along with higher capital requirements, Basel III changes the way that deposits are treated, making various categories of deposits less valuable than they once were, with a potential major impact on deposit strategy.

Each institution will need to consider how these economic trends and regulatory changes intersect with the major lines of business and

collectively impact corporate performance. One thing is for certain: successful strategies that were employed before the crisis will not generate superior results in 2012 and beyond.

### PLANNING CHANGES FOR 2012

Finance and risk managers will need to help business line managers identify the major changes and quantify their likely impact. The goal is to come up with a side-by-side analysis that permits clear comparisons of the business lines, including profit and growth potential in this new world, which can be rolled up into a corporate outlook.

This quantification becomes the foundation for executive management decisions and strategic positioning, bringing urgency to the task of completing investigations in time to support the 2012 planning process. The leadership team and board of directors will be dependent upon this information to make informed decisions.

As underscored by Bank of America's announced elimination of 30,000 jobs, cost reduction is now a burning industry priority. Yet within viable business lines, deep cuts can pose a direct threat to competitiveness, customer relationships and future growth potential. This is particularly the case given the need to retool businesses in light of the changed market and regulatory environment. Elsewhere,

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too little economizing may occur within business units that have lost financial viability in a weak economy with higher regulatory hurdles.

### ASSESSING THE FUTURE

To sort through these issues, winning banks will comprehensively assess the future economics of each business line and consider cost reduction within that context.

Meanwhile, an equally intense effort is needed to nurture growth wherever it can be found. Over the next few years, for example, we believe that banks will play a much larger role in carrying residential mortgages on their balance sheets. Perhaps up to \$2 trillion of mortgages will move onto the balance sheet as banks claim balances that formerly went through securitization conduits, or to Fannie Mae and Freddie Mac.

What's still lacking at many banks, however, is a plan to win this business. A coordinated effort will be needed to harness the regional branch system. It is important to keep sight of such opportunities as the wildfires of cost reduction rage.

Another planning factor is risk measurement, which will be more complex going forward (e.g., with more mortgage and multi-family loans held on the balance sheet). Most plans have not adequately considered long-term strategic risk. That is, many measures of risk-adjusted returns are based on some form of one-year credit risk exposure, but do not consider the durability of estimates over the full economic cycle.

Advanced stress testing should factor into decisions on resource deployment. That is, does the return expected from a business justify the worst-case loss that potentially could be suffered?

For example, how does the

cumulative five- to seven-year expected return compare with the worst-case loss scenarios for each strategy? On this measure are there businesses that have superior risk/return relationships relative to others? If so, how should cost reductions be apportioned across these businesses?

In reviewing these factors, the main point is that a holding pattern won't work going into 2012, nor will a simple across-the-board expense reduction program. Because of regulatory and customer behavior changes, banks must undergo a complete rethinking and repositioning of their business models.

Instead of a collection of one-year business line plans, banks will need a multi-year vision to rebuild for a permanently changed market. Banks that ignore the long-term implications of this changed environment are at risk of making fundamentally wrong expense reduction and investment decisions for 2012.

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