

# Efficiency, Growth and Risk: Striking a Critical Balance

BY STEVE TURNER AND J.D. RICHARDS

Over the last three years finance and risk managers have been preoccupied with pressing issues stemming from the global recession. But as institutions move out of crisis mode they face a new set of challenges that, while not life-threatening as before, are equally daunting and possibly even more complex.

The main problem is that revenue shortfalls abound at a time when many initial cost-cut programs have largely run their course. Facing further revenue challenges and a round of deeper cuts going into next year, banks must make some difficult budget decisions, many affecting multiple business lines and the customer experience.

In addition, the economics of many banking lines of business are being fundamentally changed by new regulations. There's more beyond the immediate impact of reduced debit interchange and checking overdraft fees. Banks must adapt to higher requirements for capital and liquidity; greater risk accountability for many instruments that previously were held off balance sheet; and more stringent risk measurements that more explicitly anticipate extreme occurrences but lower business valuations in so doing.

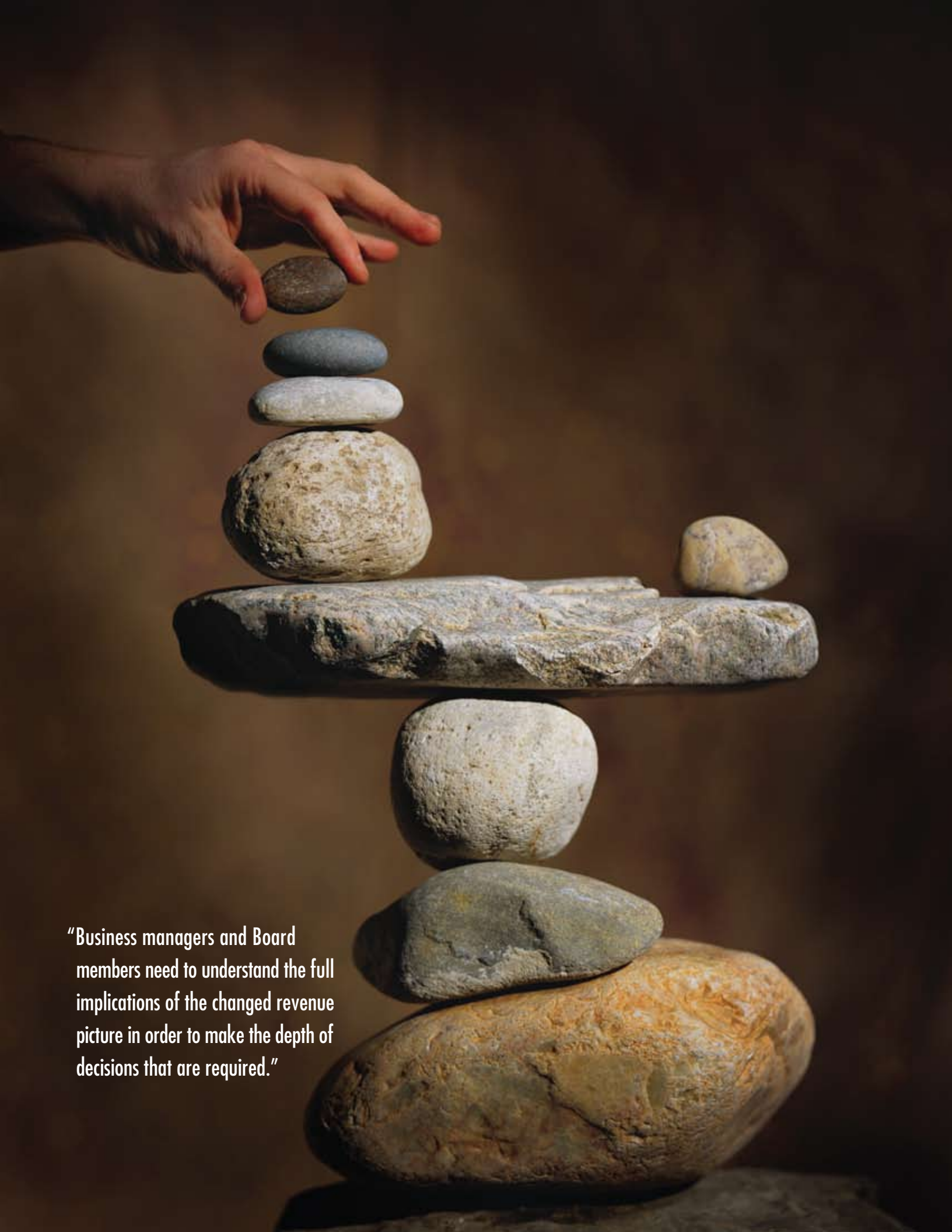
This union of short-term revenue weakness and long-term structural change in the value of various business lines will be difficult for many institutions to navigate. Facing mounting pressure for deeper cost cuts, for example, executive leaders will be tempted to mandate across-the-board expense reductions.

While it can be politically expedient to "spread the pain" evenly across the business lines, there is a pronounced risk in reducing capabilities that are core to the future of the institution. Meanwhile, too little economizing may occur within business units that have lost financial viability in a weak economy with higher regulatory hurdles.

The situation introduces a pivotal role for finance and risk managers. They must take the lead to frame the issues; quantify the implications of alternative actions; and guide the institution to effective resolution of priority issues.

Banks will need much more than a collection of one-year plans for their various lines of business. Executive management must look comprehensively across the organization to allocate resources to support growth, and also find ways to reduce costs with minimum impact on revenues and customers.

Both finance and risk managers will need to provide three major types of support, including: 1) sizing and communicating the revenue gap problem; 2) fostering further cost cutting; and 3) framing resource deployment decisions for growth. In many cases, these initiatives will spawn the



**"Business managers and Board members need to understand the full implications of the changed revenue picture in order to make the depth of decisions that are required."**

## “Businesses that look good historically, and possibly still do, may not meet the hurdles when changes to liquidity and capital requirements are overlaid.”

creation of new financial tools that will be indispensable to the organization over the long term. This is part of the overall progress that banks will need as they reposition for a permanently changed market.

### REVENUE GAP

Business line managers are generally aware of looming revenue challenges and the changing regulatory framework. Few, however, have fully quantified the expected financial impact over the next few years. This leaves the parent company and board of directors without a clear picture of how changing market and regulatory dynamics will affect business line and corporate results.

To prepare for the depth of decisions that will be needed, executive management, business line managers, and bank directors need to understand the full implications of the changed revenue picture. Quantification of the revenue gap is essential in separating short-term issues from strategic shifts in business models.

Looking first at short-term performance, there are three main issues:

- First, there is a dwindling trend of falling loan-loss provisions. As troubled portfolios stabilized, banks were able to reverse loss reserves back into earnings, providing an immense cushion for business line revenue gaps in 2010 and 2011. This earnings cushion will be largely exhausted going into next year.
- Second, the weak economy, commercial borrower reticence and battered consumer balance sheets will put a damper on loan growth in most sectors.
- Third, expense structures remain bloated from supporting growth at prior levels unlikely to reappear in 2012.

In addition, banks will need to consider the larger ramifications of the Dodd–Frank Wall Street Reform, the Consumer Protection Act and the new international rules on capital and liquidity standards as implemented under Basel III. Fee limitations on debit interchange and checking overdraft coverage have caught industry attention and will clearly change the return expectations for the retail demand deposit business. But other changes will affect overall returns and individual business lines to an equal or greater degree, particularly new liquidity and capital requirements.

Basel III liquidity requirements limit the ways that deposits can be invested by requiring banks to hold certain minimum

levels of liquid assets (e.g., Treasuries) in tandem with various deposit categories. These thresholds range from 5% for highly stable deposits to 100% for deposits from other financial institutions and similar market participants.

This will have the effect of driving more funds into low-yielding assets and limiting the availability of deposit funding for other business activities. Various lending and investing units will either have to turn elsewhere for more costly supplemental funding or simply scale back, reducing the economic value of their activities.

Basel III will also require banks to hold higher levels of core capital, which seems certain to dilute earnings per share at a time when revenues are under assault on multiple fronts. We estimate that the average financial institution will see a drop of three percentage points in return on equity as a result of Basel III and Dodd-Frank. And the impact likely will be even heavier on Systematically Important Financial Institutions (SIFIs), as defined by the newly-formed Financial Stability Board.

Even in the unlikely case that a bank could return to pre-recession earnings levels, it still would struggle to meet hurdles for shareholder returns under new and more stringent capital leverage rules. This underscores the need for transformative change in various business lines.

Finally, the Dodd-Frank regulation on proprietary trading, commonly known as the “Volcker Rule,” will change the business models of some of the largest U.S. financial institutions. This will have cascade effects on hedging and securitization activities. There could be significant changes in reporting requirements as well, and in rules governing the time span that securities can be held in the course of customer transactions.

Each institution will need to consider how these economic and regulatory trends intersect with the major lines of business and collectively impact corporate performance. Finance and risk managers will need to delve into the major business lines, identify the major types of exposure 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, and that 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 for robust decision-making.

### DEEPER COST CUTS

Cost reductions will be difficult in 2012. The easier possibilities already have been pursued and largely will be exhausted in 2011, leaving institutions to consider more pronounced measures that will more strongly affect future business capabilities and the customer experience. A further complication is the fact that many businesses will need to rethink their business models and begin to reposition for a changed market.

Finance and risk managers must make sense of these crosscurrents to guide business managers on the actions they will need to take. This includes leading the debate, providing the measurements needed to support critical decisions, and providing ongoing measurements of organizational progress on agreed changes.

Metrics are needed that will provide a useful framework for the discussion. These metrics should separate three things: 1) Core profitability from customer/product combinations (e.g., risk-adjusted return from a home equity loan); 2) The cost of creating and supporting these combinations (e.g., delivery channel costs, systems support); and 3) The cost of corporate infrastructure (e.g., the corporate jet).

**“Banks must keep sight of growth, ensuring that the best opportunities are accurately identified and properly nurtured, keeping sight of risk-adjusted returns.”**

Figures on core profitability and corporate infrastructure can often be isolated fairly quickly. But supporting costs can be difficult to cleanly assign to one business activity and often need to be estimated considering joint usage of resources. Often, expense cuts that span multiple business lines present the greatest opportunity, but they are also the most complex to implement. The branch system, for example, is shared by the consumer banking, small business banking and wealth management business units.

With metrics in place, cost-cut options will need to be modeled, analyzed and reviewed for unintended consequences. Issues with cross-organizational structure alignment will need to be hammered out.

Future economics must be kept in mind. Traditionally solid businesses may not meet planning hurdles when new liquidity

and capital requirements are overlaid. These businesses will need to be reviewed for alternative ways to improve or revise the way returns are generated in a changing environment. This goes beyond near-term cost analysis.

### FRAMEWORK FOR GROWTH

Ultimately there will be many changes in business strategies, leading to additional questions about growth potential and the best way to deploy supporting resources. Here, finance and risk managers will be called upon to provide solid financial measurements that can be used to compare business line growth potential and set expansion priorities.

As banks work through this process, many will face three prominent themes: mortgage lending; transitions in delivery channels; and advanced risk measurement.

**Mortgage lending.** Following the crisis in mortgage securitization and the crippling of Fannie Mae and Freddie Mac, bank balance sheets likely will become a growing destination for residential mortgages.

The good news is that mortgage expansion can make a real difference at a time when higher-yielding assets are hard to come by. With hundreds of local mortgage brokers gone from the market, regional banks have the opportunity to drive substantial origination volume through their branch networks.

Over the next few years, we estimate that the banking industry will book roughly \$2 trillion of additional mortgage credit. Along with presenting credit and collateral hurdles, these mortgages will put additional pressure on capital and liquidity resources.

This has substantial implications for risk management. According to Novantas research, the industry-wide average for loan-to-value ratios on mortgages has soared from less than 40% to more than 60% since 2006, meaning there is a much smaller equity cushion. Currently, about 10% of U.S. households owe more on their homes than market value.

Selectivity, therefore, will be a key winning trait in mortgage expansion. Banks will need an analytical understanding of local housing dynamics so they can pick the right openings in a highly uneven market. Underwriting processes are already being strengthened, but many banks have more work to do in pricing for risk-adjusted returns.

Additionally, mortgage origination in a low-rate environment can carry significant interest rate risk, as the former savings and loan industry experienced. Typically balance sheet lenders must manage a maturity mismatch that has funding rolling over at a faster pace than assets, meaning that interest expense can rise much more swiftly than loan yields in a potential era of rising rates. Finance and risk managers will play a lead role in managing this type of exposure.

**Delivery channels.** In an overgrown retail delivery system, banks must find the best revenue generation and productivity improvement possibilities while carefully paring back. In the current environment, customer relationship expansion is the number one path to growth, and finance managers will work in tandem with the branch and retail banking teams to identify and nurture the best possibilities.

**“Executive management should allocate resources comprehensively across the organization to support growth, and reduce costs with minimum impact on revenues and customers.”**

Meanwhile, there are trade-offs to be made among the various local markets served by the branch network; trade-offs between physical and electronic delivery; questions regarding branch staffing levels, job roles and sales productivity; and questions about customer migration to self-service arrangements.

Many institutions are already cutting weak branches, but further sharp reductions in delivery costs will be needed. Managers will face a delicate balancing act as they attempt to economize how products and services are delivered while simultaneously working to maintain and improve the customer experience.

**Risk-adjusted returns.** Regulatory and economic forces are mandating a greater emphasis on forward-looking risk measures, which will be needed to make finer decisions on credit and business opportunities. Risk measurement will be more complex going forward, with more mortgage and multifamily loans held on the balance sheet.

Most plans have not adequately considered long-term strategic risk. That is, most measures of risk-adjusted returns are based one-year credit risk exposure, but do not consider the durability of estimates over the full economic cycle.

Advanced stress testing, or so-called “tail risk” measures, should be factored into decisions on resource deployment. These measures should answer several questions: Does the return expected from a business justify the worst-case loss that could potentially be suffered? 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?

## LEADING THE CHARGE

As banks prepare for 2012, finance and risk managers will need to lead the charge to align future strategies with the changing circumstances that financial institutions face. Business line managers will need help in gaining perspective on the size of the problem that they are facing individually, and that the corporation is facing collectively.

The planning challenges are unlike any seen in memory, both in size and complexity. The low-hanging fruit in cost reduction was consumed in 2011, and further choices will be more difficult. Even more regulations are coming down the pike that will affect business line performance and profitability. Yet banks must keep sight of growth and make sure that the best opportunities are accurately identified and properly nurtured, keeping sight of risk-adjusted returns.

Leading finance and risk teams are already at work on this multi-faceted challenge while others need to catch up. Banks will need critical information and guidance that only they can provide.

---

*Steve Turner is a Partner in the New York office and J.D. Richards is a Partner in the Chicago office of Novantas LLC, a management consultancy.*