

## How Healthy Are the Banks? Time to Focus on Value

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*By Neal Kissel, Ron Langford and Marina Belezina*

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The recent 2009 results season delivered some long-awaited good news. Earnings are up at major banks and share prices are also on the way to recovery. So, is the worst over? And, more importantly, how healthy are the banks today?

Our research indicates that the industry is not 'out of the woods' yet... not by a long shot. Major banks are not forecasted to earn their cost of equity capital in 2010–11. This is neither 'healthy' nor sustainable.

Banks cannot build a healthy banking system alone, but there is no shortage of things that good management could do and needs to do. Improving returns relative to risk should become the key strategic priority for management in the near-term. Most banks will also need to change in fundamental ways to sustain value growth over time.



## Perception versus Reality

Headlines report improved earnings, but our research shows that most banks remain “in the red” economically.

We analyzed expected returns relative to risk for major bank holding companies in the US, Europe and Asia, comparing expected return on equity in 2010–11 with the cost of equity capital – the return investors expect for the investment risk they take when buying shares.

The analysis indicates that major banks are failing to earn their cost of equity capital.

As shown in Figure 1, only four US banks, or 10% of banking equity capital, are expected to generate returns above the cost of equity; a staggering 90% of banking capital is not performing.

Figure 2, on the next page shows UK and European banks are in a similar situation. Only nine major banks are expected to earn above their cost of equity.

The situation is somewhat different in Asia. In the aggregate, the industry is expected to earn returns just under the cost of capital, but performance varies widely across the region. Chinese banks benefit from a more favorable domestic environment and appear ‘healthy’, whilst most Japanese banks are unprofitable. Banks from India, South-east Asia and Australia generally fall in the middle.

The economy and recession have certainly had an impact. Even when factoring in the changes to the banking environment over the past two years the data still shows serious signs of distress.

Proposed regulatory reforms are likely to put further pressure on returns – analysts estimate additional reductions in equity returns of up to 8%. The UK, Europe and the US will be most severely affected.

## What It Means

Banks are not ‘out of the woods yet’... not by a long shot. A banking system where the majority of the players do not return the cost of capital to their shareowners is neither healthy nor sustainable.

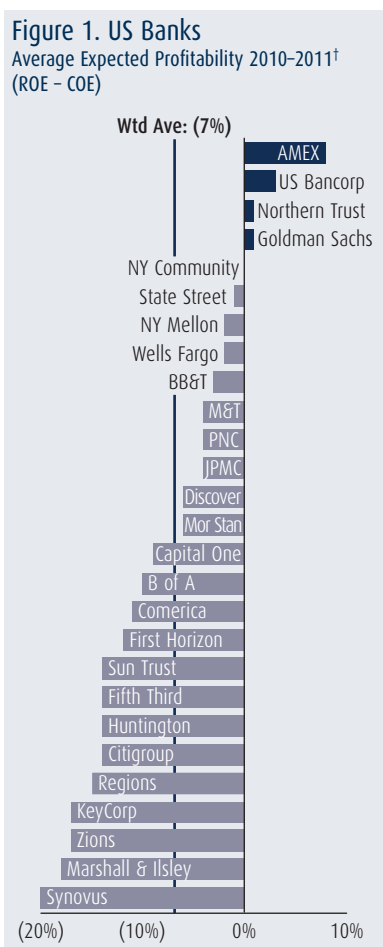
It’s not just good management that separates the winners from the losers. The macroeconomic conditions and fiscal policy they work within also play major roles, and the environmental and cultural conventions of some countries are more supportive than others.

Banks cannot build a healthy banking system alone, but there is no shortage of things that the banks could do.

## How to Respond

Improving returns relative to risks should be the key strategic priority for bank management in the near-term. However, in order to sustain value growth over time, most banks will also need to change in more fundamental ways. The importance of a value creation mindset and discipline is far greater today than ever before. A value creation mindset shifts the focus from ‘earnings quantity’ to ‘earnings quality’ (manifested in company P/E ratios). Not all earnings are ‘good’ and not all risks are ‘bad’. It is managing value drivers – profitability, growth and risk – together, rather than each separately, that results in superior value creation.

Six ideas can help banks go a long way towards improving returns while also strengthening their businesses for the long haul.



† Source: Thomson One, Bloomberg, Marakon analysis. Major bank holding companies by assets and/or market capitalization; Return on Equity is the analyst consensus expectation; Cost of Equity is calculated using local market risk premium, risk free rate and company beta – average of current beta and pre-crisis beta.

## 1. Allocate capital to the highest value use

The best banks have strong discipline in place for managing capital, not just earnings. Banks don't have unlimited capital, so they need to get the highest return on their scarce resources. The importance of differentiating between 'good' and 'bad' opportunities is far greater today. Since investing resources behind economically unprofitable businesses does not make sense, banks are facing a stark choice: turn these businesses to profitability or 'fire' customers and sell businesses to release capital. To more sharply manage their portfolios, banks need to build a granular understanding of where they are creating or destroying value (which geographies, customers, products and where along the originate-hold-service value chain) and improve at rapidly redirecting capital towards the highest value opportunities.

## 2. Capture missing risks to intrinsic value

Less than half of the change in banks' market value during the current crisis can be explained by changes in the fair value of financial assets – the rest is unaccounted for. Why is that? Bank executives and investors only see the tip of the iceberg. Even the most advanced measures of risk appear to be missing significant 'chunks' of risks to a bank's intrinsic value, such as liquidity, value of service assets and future business value. Underlying systemic risks that cut across multiple activities are also not well understood (e.g., exposure to property prices, GDP growth, oil price and commodities, etc.). There is a need to rethink how risk is measured and managed along a number of dimensions. Firstly, a more comprehensive 'top-down' framework that helps to understand how individual activities impact total company risk is needed (the "Risk Balance Sheet" is one example of such a framework). Equally, if not more, important is developing the mindset, capabilities and behaviors necessary to incorporate 'risk thinking' into strategic decision-making.

## 3. Get smarter on pricing

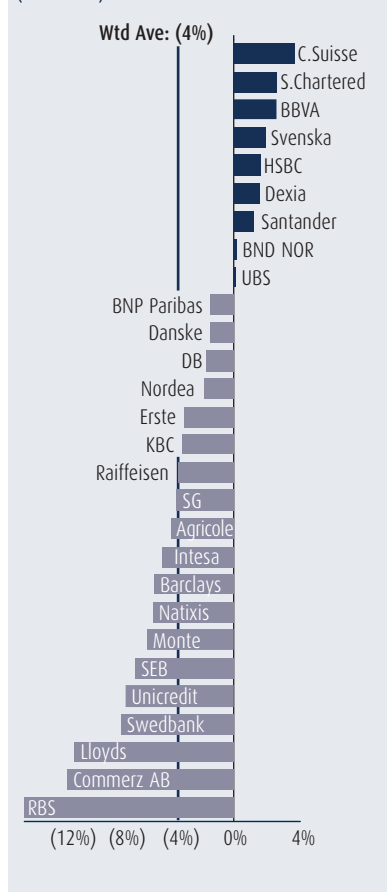
Just before the crisis, banks were tripping over themselves to acquire new business,

often competing on price. As a result, price levels in many markets (e.g., consumer and commercial credit) were hardly economical or sustainable. In the 'new normal,' the key drivers of economics – costs, capital, and customer behaviors and willingness to pay – have shifted dramatically, mostly downwards. Yet, most banks have been slow to adjust pricing to reflect this (beyond rate increases to account for rising credit losses). Building a more sophisticated pricing capability will be critical for banks to rapidly improve returns and gain a competitive edge. At a minimum, banks need to have a good understanding of break-even pricing for their individual customers or products when all costs are taken into account (e.g., cost of capital or liquidity), and how this compares with customer willingness to pay. Bridging the gap to economic profitability will also require banks to become more sophisticated about pricing models and practices (e.g., fee vs. rate mix, price differentiation, bundling and unbundling, and timing of re-pricing) to influence customer behaviors.

## 4. Focus on customer benefit and realign costs

Many banks mistake 'customer focus' for 'customer benefit focus.' This frequently leads to the proliferation of products / features which customers 'want' but are not prepared to pay for and a bloated cost structure. While progress has been made in scaling down the most visible excesses, the hardest work to bring down costs is still ahead. Improving profitability without sacrificing growth requires banks to explicitly tie costs to customer benefits and understand the true elasticity of demand – up and down – relative to changes in their offer. This would give banks an important toolkit for managing costs. For example, using 'smart clustering' of branch formats, capabilities and services for different customer communities is a way to remove excess distribution costs. Leveraging a deep understanding of customer needs vis-a-vis the current offer will help to redefine (rather than optimize) the product offer, marketing mix and operating configuration.

**Figure 2. UK and European Banks**  
Average Expected Profitability 2010-2011†  
(ROE - COE)



† Source: Thomson One, Bloomberg, Marakon analysis. Major bank holding companies by assets and/or market capitalization; Return on Equity is the analyst consensus expectation; Cost of Equity is calculated using local market risk premium, risk free rate and company beta – average of current beta and pre-crisis beta.

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## 5. Refocus on competitive advantage

Banks will clearly benefit as recovery takes hold. However, simply riding the yield curve is unlikely to be sufficient to meet investor expectations, and certainly will not be a source of competitive advantage. Now is the time to revisit a fundamental question: 'What type of bank do we want to build and how will it be distinctive from other banks?' If there is one lesson to be learned from this crisis, it is not to 'follow the herd' blindly (e.g., the scale of industry investment in sub-prime). Banks need to become much more selective and distinctive in their choices about which customers to serve with which offers, which risks to take and how to add value. This is likely to result not only in stronger performance by individual banks, but also in a more diverse, and therefore sustainable, banking system.

## 6. Align behaviors with value creation

Much has been said recently about excessive risk taking by banks and the compensation practices that fostered this behavior.

However, these are both symptoms of a bigger problem – managers are not focused on value creation. There is no doubt that compensation principles need significant improvement. Too much focus has been placed historically on earnings and not enough on returns relative to risk, too much emphasis on quarterly results and not enough on multi-year performance and intrinsic value growth, too much weight on absolute results and not enough on value-added. However, the key for resolving this problem is changing beliefs and day-to-day decision practices of the line managers. Value creation should replace near-term earnings as a governing objective and belief system if banks are to ensure the stability of their business through the cycle and sustain superior value growth for shareholders over time.

*Banks need to go 'back to basics' and embrace the management disciplines and practices that underpin managing for value. These principles could create a strong platform for addressing the challenges and opportunities banks face in these continued turbulent times.*

## About Marakon

Since its founding in 1978, Marakon has partnered with senior executives of the most respected companies to help them fundamentally increase and realize their potential to create value. Hundreds of companies from around the world have adopted our approach to helping them improve their business models, operating and management practices. One measure of our success is the long-standing relationships we have with many world-renowned companies and their continued outperformance.

Today, we are focused on helping companies in their pursuit of managing for value as they adapt to the new economic reality, when the need for business and management model innovation is greater than ever.

Marakon has never found that industry solutions and armies of consultants are the best way to have significant impact. The keys to helping business leaders unlock value are tailored solutions and constructive challenge. We provide a focused team of senior professionals to work in partnership with our clients to drive results and superior decisions.

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