strategy+business

ISSUE 65 WINTER 2011

The Right Side of Financial Services

Financial institutions need new strategies — to rethink portfolios, customer-centricity, and risk — for the neglected side of their balance sheets.

BY GAUTHIER VINCENT

REPRINT 00089

This article was originally published by Booz & Company.

The Right Side of Financial Services

Financial institutions need new strategies — to rethink portfolios, customer-centricity, and risk — for the neglected side of their balance sheets.

by Gauthier Vincent

The great financial meltdown of 2008 unmasked a truth that management teams at banks and financial institutions had clearly lost sight of: The right side of the balance sheet matters. For many years leading up to the crisis, the financial-services industry by and large dismissed the importance of the right side. This is the part of the ledger that lists customer liabilities (for example, bank deposits and insurance premiums), debt, and capital — the money on hand to fund loans and other assets (the left side). Without the proper blend of liabilities to fund their assets, banks and financial institutions are vulnerable to economic upheavals, during which fearful clients may withdraw their deposits or capital markets may suddenly become unwilling to roll over an institution's debt — and they risk sharp declines in shareholder value or even total or near collapse. This was the fate of Lehman Brothers, Bear Stearns, AIG, Citigroup, and Bank of America.

Right-side strategies aim to find an effective mix of sources of funding on the right side of the balance sheet, taking into account their cost and duration in good and bad times, to support asset growth on the left side and adequately cover losses in asset values. Through much of the past couple of decades, financial-services firms tended to ignore the right side because they were under pressure both to aggressively grow assets to drive improvements in revenue and earnings and to release "excess" equity to boost returns and enhance valuations. Moreover, the lack of transparency in the valuation of certain complex financial instruments (such as mortgage-backed securities and derivatives) along with loopholes in regulatory capital frameworks — for example, in the treatment of off-balance-sheet exposures — made it easier to neglect right-side strategies. Over time, this approach created elevated risk levels at some firms. In today's financial-services environment, it is clear that sustainable shareholder value creation (and protection) has as much to do with the right side as with the left side of the balance sheet. In short, right-side strategies matter more now than they ever have mattered before.

To be fair, since the onset of the recession and the subsequent bank bailouts, the financial-services industry has made progress in recalibrating the importance of the right side of the balance sheet. Overall, industry capital ratios have improved. Some firms have reduced their reliance on more unstable sources of funding and increased the stability and duration of their borrowings. Moreover, lending business models that depended almost exclusively on capital markets for funding have all but disappeared.

But most of those changes came in the immediate wake of the worst of the great financial meltdown; the urgency to craft long-term right-side strategies has begun to recede in recent months. And as the crisis mentality wanes and short memories take over, one thing is becoming more and more apparent: If there is another dramatic shock to the financial system, the outcome is likely to be just as devastating to the industry as it was in 2008.

Illustration by Joyce Hesselbirth

Financial-services firms should consider three types of right-side strategies. They are built, respectively, on changing the company's portfolio, becoming more client-centric, and using economic capital to help rethink risk and capital strategies.

Shifting the Portfolio

A portfolio strategy involves changing the blend of the company's holdings through acquisitions and divestitures, or through other types of organic growth across the company's businesses. When there is a right-side focus, this means increasing the influence of businesses that are rich in client liabilities or that require less capital, as well as shrinking businesses that mostly generate assets and drive up capital requirements.

Capital One's tale of near demise and subsequent revival illustrates the value of this approach. Through the 1990s, Capital One aggressively grew its base of credit card assets on the back of superior credit and segmentation skills. The company demonstrated an industry-leading ability to plumb databases of potential clients and offer segmented demographic groups a range of credit cards with various rates and rewards. By the early 2000s, Capital One had leveraged these capabilities across new asset classes such as auto loans. To fund these accounts, Capital One's strategy was simple: Rely primarily on bond issuances to match asset growth.

But in 2003, Capital One's strategy came under attack as concerns suddenly surfaced about the credit quality of some of its assets. Almost overnight, the company faced resistance in capital markets to rolling over its debt. Its share price fell abruptly by nearly 50 percent, as many investors feared that the company could not survive much longer as a stand-alone entity.

This near-death experience, several years ahead of the credit and funding crisis of 2008, became a blessing in disguise. It forced Capital One's senior management to rethink the right side of their balance sheet to regain the confidence of Wall Street and the bond markets. After this reappraisal, Capital One acquired two retail banks: Hibernia and North Fork (in 2005 and 2006, respectively), two retail operators with large portfolios of plain-vanilla savings and checking accounts. These sticky, low-cost, and stable funding pools were precisely what Capital One needed to alter its balance sheet mix and provide long-term funding for its asset base.

Just a few years ago, few would have thought that Capital One could withstand a credit crunch of any magnitude. Yet not only did the company hold its own throughout the industry collapse, but its share price outperformed those of most financial stocks. In fact, this retail bank acquisition strategy has worked so well for Capital One that the company continues to embrace it today, recently anteing up US$9 billion to purchase the online bank ING Direct. Capital One's experience shows how portfolio strategies can strike the appropriate balance between "client asset rich" and "client liability rich" businesses. Relying solely on wholesale markets and brokered deposits for funding is no longer a solution for many consumer or commercial banks. Instead, access to low-cost, stable funding, such as consumer or commercial deposits or even pools of insurance, is essential to long-term viability.

Of course, Capital One is now operating with retail banking businesses that are quite different from its core card business. It must thus develop the right set of business capabilities to be successful at these new businesses, lest its financial performance be weighed down by poorly run retail banks with poorly differentiated business models.

> **Pursuing client-centric strategies at the business unit level can go a long way toward stabilizing the right side.**

Becoming Client-Centric

Pursuing client-centric strategies at the business unit level can go a long way toward stabilizing the right side of diversified financial institutions. A client-centric strategy involves a transition from emphasizing individual products for all types of customers to serving a broad range of financial needs for a particular group of clients. These clients often require loans and have liquidities to park with their financial partner, for instance in the form of deposits; they could represent a desirable blend of left- and right-side contributions to the balance sheet.

Silicon Valley Bank, a midsized commercial banking firm, provides a good example of this strategy. Most of the bank's asset growth in the last five to 10 years has come from venture capital clients. Working with these entrepreneurs, the bank discovered that the venture capitalists were often at two distinctly different points in their funding cycles: Some had credit needs (for instance, before they could issue capital calls to their investors); others were flush with liquidity (for instance, after they had received investor funds and as they gradually put these funds to work).

Recognizing the opportunity, Silicon Valley Bank implemented a client-centric strategy in which specialized sales and product teams pursued venture capital customers for both cash management and loan activity. The goal was to develop broader product development capabilities to serve both sides of the venture capital firms' balance sheets, as opposed to merely trying to provide credit to them. By doing this, Silicon Valley Bank was able to fund its loans to venture capital customers with extremely low-cost and low-risk deposits from other venture capital outfits. In choosing this client-centric strategy, the bank put itself in a strong position with stable, low-cost funding (two-thirds of its deposits are non-interest-bearing) and balanced growth in client assets and liabilities.

This approach is also applicable to large, diversified financial firms, as long as they are willing to develop the appropriate new product and organizational capabilities. A good example of a major company that has begun to adopt a client-centric model in parts of its business is American Express. Long focused primarily on developing new charge and credit card products for its members, in recent years American Express has promoted a new brand called Open, which offers small businesses a wide range of services from credit cards to payments to social networking. By continuing to broaden its suite of offerings to small businesses, American Express may soon be in a position to access new pools of liquidity (for example, small-business deposit accounts) and greatly alter the corporation's funding profile, perhaps relying less on capital markets.

Rethinking Risk and Capital

Observers outside the financial-services industry have long believed that banks and financial institutions were experts at managing risk and capital; it was generally accepted that their business model was driven by those skill sets. However, the credit collapse revealed that this was not the case. In the decade preceding the global crisis, risk and capital management had become more disconnected at many large banks and financial companies. Chief risk officers and their teams focused on managing risk exposures with little regard for the bank's capital structure. Meanwhile, the chief financial officers and their teams exploited loopholes in regulatory capital frameworks to continually lower the cost of capital on hand and boost returns while largely ignoring increases in risk.

A framework did (and does) in fact exist for tying risk closely to capital, but its importance was largely ignored. It is a concept known in the financial-services industry as economic capital. This set of algorithms and practices is used to translate a firm's multiple risk exposures into the amount of equity capital that it needs to protect shareholders against insolvency.

To minimize the chances of another financial-services meltdown — raising the specter of dozens of additional failed banks, big and small — boards and management teams must take the lead and create a new risk culture in which economic capital is the organization's currency of risk, right- and left-side capital strategies are tightly integrated, and the responsibility for managing risk and capital is broadly shared within the firm. For this to become a reality, several things need to happen: Boards and senior management must become more knowledgeable about right-side strategies and economic capital; economic capital algorithms and systems need to be upgraded to account for new sources of risk; economic capital must be an essential data point in all pricing and investment decisions at all levels of the organization; and performance assessments must factor in the cost of economic capital usage, not just profits. For many banks, this represents a difficult path; it entails a significant upgrade in their risk and capital management capabilities.

Because financial services is a highly leveraged industry, balance sheet management can never be neglected without dire consequences. The events of the last three years have reminded us that strong funding and capital positions are sources of long-term competitive advantage and value creation. They have clearly demonstrated that financial institutions can ignore right-side strategies only at their peril. The opposite is true as well. Banks that capably and actively manage both sides of the balance sheet will no doubt be the survivors — the industry leaders — well past the next global financial debacle. +

Reprint No. 00089

Gauthier Vincent
gauthier.vincent@booz.com
is a senior executive advisor with Booz & Company's financial-services practice in New York. He advises senior management at banks and financial companies on corporate strategy, managing for value, and business unit growth strategies.

strategy+business magazine
is published by PwC Strategy& Inc.
To subscribe, visit strategy-business.com
or call 1-855-869-4862.

For more information about Strategy&,
visit www.strategyand.pwc.com

• strategy-business.com
• facebook.com/strategybusiness
• http://twitter.com/stratandbiz
101 Park Ave., 18th Floor, New York, NY 10178

pwc | strategy&
Formerly Booz & Company