Banking on the future

Banking consultants do not like gazing into crystal balls. But in the latest in our series from leading consultants, **Steven Davis** takes a shot

What do I foresee to be the changes in the financial services sector in the next five years?

Having to make such a forecast fills this particular consultant with terror – especially given the appalling track record of my peers over the years. It was we who decided that the internet would replace the bank branch; we who applauded when banks destroyed even more stockholder value by buying insurers and fund managers at the top of the market in 2000; and we who recommended vast spending on complex customer relationship management systems.

But what I can do is to analyse the underlying trends of the past few years and highlight some of the issues management will have to address as they play out.

First, bank deal-making will continue, creating larger and more complex conglomerates that will be even more difficult to manage than the current leaders such as Citigroup and JP Morgan.

While strategy consultants plead for focused, organic expansion, the market seems to respect only double-digit annual earnings per share growth. As it is a rare institution that can achieve that organically, the response is often a steady diet of acquisitions. So many of the specialists that have done so well disappear into the maw of these conglomerates.

The destruction of value in the merger of financial institutions cannot be really measured, but it must surely be substantial. One of the findings of my book several years ago on bank mergers was that only a handful of merging banks bothered to keep separate books on the pure incremental value of acquisitions. Those that did found significant shortfalls in projected merger gains.

The standard measurement of value added is the price movement of stock market in the merged bank. The flaw in this analysis is that using a period of several years – when the value is presumably earned – introduces a host of other variables, while a period of days or months has little to do with the value actually earned by the combined entity.

We see financial institutions buying into new businesses – hedge funds, private equity, commodity trading, emerging markets – in which they have little or no experience. This multiplies the potential conflicts of interest, dilutes the existing culture, poses new risks and raises the issue of a conglomerate discount. Just ask Citigroup, which currently sells at a discount of perhaps 25 per cent to its theoretical, peer-based value in the view of iconoclastic analysts such as Tom Brown in New York.

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At the same time there will be a move to dispose of existing businesses as management is forced to sell second tier or non-performing units in their struggle to improve earnings growth. We have seen this in fund management, global custody and marginal units in central and eastern Europe. Citigroup's divestiture of its fund management business, which followed that of its insurance acquisitions, was a seminal event which should be followed by others who focus on their competitive strengths, not breadth of activities.

In short, advising financial institutions on M&A will continue to be a great business.

Second, the performance game in the investment world will collide with the universal principle of reversion to the norm. The search for "alpha" – out performance of the averages – has attracted a wave of corporate, institutional and private money. Not surprisingly, it has been met by a proliferation of aspirant hedge fund and private equity firms, as well as traditional long-only managers, who promise such results. But history and logic argue that only a fortunate few providers will succeed in doing so.

The wave of money already flows to a minority of presumed winners, and the hundreds of new hedge funds are being matched by those who silently close their doors. A Morningstar hedge fund rating for such newcomers, to enable investors to follow their ratings, is surely only a matter of time. For a bank with a major investment in a poorly performing asset manager, the choices are stark: sell at a loss, close it down, or invest perhaps three years and considerable money and talent in rebuilding it under new leadership.

Third, competition and slower growth of retail banking as developing markets mature will reduce annual profit growth to the low single digits. Pricing pressures, often in the form of advantageous packages, will shrink margins on traditional lending and deposit products. Cross-selling, for most, will prove a zero sum game, as a combination of client resistance, poor selling skills and motivation, and bureaucracy impose major barriers.

Our research has shown that a low cross-sell ratio does not imply that it will increase with effort, but rather that competitive and other forces will probably restrain it. And there is little evidence that clients actually want to buy more from a single bank. The answer for many banks in Europe is to enter less developed markets, but there are limits to this solution – especially if they involve paying four to five times the book value.

With this profit pressure will probably

come increased regulatory attention. The Financial Services Authority (FSA) is a pathfinder in its efforts to combat misselling - the sale of retail products not suitable for the clients. There is a correlation between high margin products, such as guaranteed capital bonds, credit life or mortgage protection insurance, payment protection insurance and non-standard mortgages, and the risk that they may be oversold to an unsophisticated buyer. The FSA's "Treating Customers Fairly" initiative may well find echoes in other markets where regulators and politicians are concerned about misselling.

Finally, the financial world is waiting for the almost inevitable consequences of today's bull market in risk-taking. As usual, we do not know when and how the bust will take place, but it will. Stretching lending leverage ratios, creating new derivative products, taking on bigger exposures to newcomers to the market: all justify the recent formation of workout groups by smart investment bankers gearing up for the inevitable fallout.

Will it be a hedge fund collapse such as LTCM? A $33bn private equity purchase of a health services provider that is undermined by a drastic cutback in government funding? A reaction to complex derivative losses such as the Procter & Gamble/Bankers Trust debacle of 1994?

It is hard to believe that banking and finance was once a boring business not known for innovation. But the creation of the derivative product back in the early 1980s has spawned a proliferation of increasingly exotic applications, which have fuelled the earnings of a handful of innovators such as Goldman Sachs, Société Générale and KBC, of Belgium.

These innovators have not only generated profits from their new products but also gained trading profits from making markets based on their intimate knowledge of buyers and sellers.

All of which points to the need for additional stress testing of banks' value at risk (VAR) models as well as recognition that the glory days of virtually non-existent lending losses are over. In particular, one can assume that liquidity will dry up as it has in virtually every crisis in the past few decades.

But there is one more prediction – one that might transform bank stock valuations. For decades, bank stocks have sold at earnings multiples well below market averages. Sector advocates point to the double-digit returns on equity consistently earned by banks across the globe, the steady growth of earnings – if not at a double-digit pace then close to it – and the improved quality of bank management. We have come a long way from the days of massive loan losses and the bloated cost to income ratios of the 1990s. The market has yet to reflect this improvement.

In PwC's survey, none of the world's 20 most respected companies was a bank

To rub salt into the wound, look at the low ranking of banks in most surveys of excellence in management. Those of you who read the bestseller 'In Search of Excellence' in 1982 by Waterman and Peters may recall that none of their case studies of excellence was a bank. Things have not improved: just look at the *Financial Times*' 2005 ranking of the world's most respected companies. It was conducted for eight consecutive years by PwC on the basis of a survey of more than 1,000 CEOs across 25 countries. Here is how banks came out last year:

In the survey, none of the world's 20 most respected companies was a bank. Only Citigroup, which ranks at number 22 and would not necessarily be on everyone's list today, ranks among the top 50. None of the ten highest ranking companies for shareholder value is a bank, and none of the top ten firms for either customer service or innovation is a bank.

Added to this, none of the top 20 most respected business leaders is a banker, although Josef Ackermann, Emilio Botin and Fred Goodwin rank in the top 50.

So what have banks done to deserve this lowly ranking? Is it a heritage of the bad old days of the 1990s, or is there something we banking consultants have missed? Here we have a sector representing perhaps 20 per cent of a country's market capitalisation and a similar share of its M&A activity. As mentioned above, the ROEs of the leading commercial banks consistently fall in the range of perhaps 12-20 per cent. In even the competitive developed markets, retail ROEs have achieved levels of 30 per cent or more - so, at a minimum, banks can be perceived as healthy cash cows for their owners. Growth rates in these markets have tapered off, but many continue to deliver the fabled "double digit" earnings growth, so sought after by everyone.

One possible answer is that the banks' standing still suffers from unhappy memories of past massive loan losses, inflated cost levels, lack of focus on stockholder value, and generally weak management.

Yet over the past decade or so, banks have typically chopped 5 to10 per cent off their cost to income ratios by, among other things, outsourcing, centralising back office functions, simplifying their product lines and eliminating marginal activities.

The use of stress-tested VAR models and the focus on possible concentrations in areas such as commercial property have reduced loss ratios from 1-2 per cent of the loan book to a fraction of that level.

But most important is the rise of superior management talent. The leadership of banks such as Wells Fargo, Deutsche Bank, RBS, Société Générale, UniCredit, Grupo Santander and their peers is a far cry from their predecessors who tried to be all things to all customers and focused on size rather than profitability.

So will banks gain more respect, as evidenced by surveys such as that of the *Financial Times*? There should, at least, be more discrimination, with the discount applying to those who are forced into mergers or diversification without having the talent to manage expansion.

But for those with a track record that shows they can manage corporate transactions as well as organic growth, to which there are bound to be limits, the discount deserves to narrow. And that could be one of the most intriguing factors over the next five years.

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