

Strategies for Revenue and Profit Growth

By John Russo

Over the last two plus years in consumer and investment banking, as well as commercial lending, revenues at large banks (mega-banks, super regional banks and large regional banks) have been shrinking significantly across the board. The continued economic slowdown, combined with the effects of new banking regulations, suggest that picture is unlikely to change without a proactive focus on reviving revenue growth. This article describes how some banks are proactively trying to create revenue growth while continuing to manage costs.

Coping with Challenges of Shrinking Revenues and Revenue Growth

Statistics compiled by Bloomberg show large commercial bank revenue fell by an average of 8 percent in the third quarter of 2010 from a year earlier, and fell 16.3 percent over the prior two quarters compared to 2009. This trend is impacting almost every business line in the financial services industry including commercial banks, investment banks, and other consumer financial service providers. Moreover, recently enacted financial reform laws led JP Morgan Chase's CEO Jamie Dimon to tell analysts that the new credit card regulations would cost his company close to \$750,000,000 in lost profits. Another provision of the law, restricting banks' ability to trade for their own accounts is also adding to reduced revenue and profits. The change in the banks' ability to have trading accounts has also had the effect of delaying new hires, downsizing staff and even resulted in the closing proprietary trading desks.

Looking ahead to the next three years, we may see revenue at U.S. banks continue to fall. Other provisions of the financial reform (e.g., The Dodd-Frank Bill) will likely reduce revenues in areas ranging from credit and potentially debit card fees to derivative fee income. As a result, many analysts are of the opinion that we may be entering the slowest period for bank growth since the Great Depression. According to Mike Mayo, a banking analyst at Credit Agricole Securities USA Inc. in New York, 2011 will kick off a decade that will bring the worst revenue growth for U.S. banks in 80 years.

Moreover, loan growth is not likely to help address this situation anytime soon. Christopher Kotowski, an analyst at Oppenheimer & Co. in New York, noted in July 2010 to investors that, in the savings and loan crisis of the 1990s, average annual loan volume didn't grow until two years after the amount of new troubled assets peaked. "Loan growth and job growth are always the last things to come back [in a downturn]," Kotowski said. "I know people are impatient because there's a lot of pain out there, but I don't think there's a way to jumpstart the process. It needs to run its course." When loan growth does return, demand for commercial loans may lead the rebound.

These trends referenced above have clearly affected bank-related shareholder value. As a result, financial services companies lagged behind the broader equities markets in 2010. For example:

1. Through the end of November 2010, financial companies trailed the broader equity market. The S&P 500 Financials Index was flat through Nov. 30, 2010, while the overall S&P 500

Index climbed almost 10 percent over the same period. Bank of America, JPMorgan Chase and Morgan Stanley were all down in profitability for the year, while Goldman Sachs was essentially flat.

2. The six largest commercial bank lenders have recently been trading at an average of 0.9 times their book value, less than half the average level over the last 10 years. Bank of America's market value through the end of November was about 53 percent of its book value, while Wells Fargo was trading at 1.2 times its book value.

In light of these circumstance and the current market conditions, how can banks get revenues, profits and stock prices up in the coming months and years?

Assessing Near-Term Strategies for Revenue Growth

Banks are looking at a range of near-term and longer-term strategies and initiatives to address projected revenue and profit shortfalls, and ultimately drive higher stock prices. In the near-term, they are looking at numerous ways to boost the bottom line. Especially in light of new regulations, many banks are attempting to generate new fee income from DDA accounts (e.g. eliminating free checking) and customer service (e.g. fees related to level of service provide or balances in the account). Other banks and broker dealers have shifted their proprietary trading operations to the less regulated hedge fund world to circumvent the recent regulations and drive growth. However, in many instances, pursuing this "riskier" growth will be out of the question for many. Data from the Federal Reserve Bank appears to indicate that other banks -- like JP Morgan Chase, Citi, Morgan Stanley, Wells Fargo and Bank of America -- have been drawing down reserves as a stop gap measure to fill the revenue void and take advantage of lower credit costs. A rise in the interest rate environment could make this approach less attractive.

Exploring Longer-Term and New Strategies for Revenue Growth

Banks have also begun to look at new avenues to drive future revenue growth. Entering markets or expanding outside of their traditional footprint (e.g., growth in overseas markets) is one avenue for growth. Penetrating households by selling additional products and services to them and doing so across multiple service and delivery platforms -- e.g., mobile banking, telephone banking and enhanced ATM services -- represents another avenue of growth. Wells Fargo has successfully pursued this path for growth for many years and, as a result, has weathered the last couple of years better than most of the large banks. CEO John Stumpf told analysts on October 20, 2010 that his bank is making up for lost revenue by offering customers service across multiple platforms -- where they shop, at ATMs, online, via telephone and mobile banking. Some analysts believe that hunting for new customers and farming an existing customer base will be the most important generators of bank growth. Therefore, generating growth will be about "taking share away from other banks," said Whalen of Institutional Risk Analytics. "At best, the global economy will be a zero-sum game."

Other banks are looking beyond traditional banking operations to drive growth. Morgan Stanley is looking for growth from its brokerage unit. It purchased a controlling stake in a joint venture with Citigroup's Smith Barney, more than doubling its brokerage ranks to about 18,000. Bank of America is

also using its brokerage unit, Merrill Lynch, to sell investment services to existing bank customers, both in the U.S. and overseas.

Managing the Expense Side of the Equation

As noted earlier, besides trying to boost revenues in the current downturn, financial institutions have been focusing on the expense side of the ledger as well. However, statistics show that expenses still have not fallen fast enough to maintain (or begin to increase) operating margins. That said, expense management and operational efficiency and effectiveness (to include possible further headcount reductions) will need to continue to play a key role in filling the gap in revenue shortfalls to drive profitability. To this end, State Street Bank announced in early November that it was reducing the size of its workforce by 5 percent due to slowing revenue streams in clearing, custody and investment banking activities. Additionally, several other financial institutions have also announced downsizing, particularly in trading and investment banking operations. Goldman Sachs, Merrill Lynch and Citi have been among financial institutions that have moved forward with downsizing.

Another area of focus related to cost reduction is looking at alternative business models, especially for non-strategic functions. As banks continue to manage the expense side of the equation, business process re-engineering (BPR), IT outsourcing and business process outsourcing (BPO) all represent opportunities for cost reduction. These approaches enable banks to restructure their operations beyond traditional, indiscriminate slash-and-burn activities. Hitachi Consulting can help banks identify BPR, IT outsourcing or off-shoring and BPO opportunities that may make the most sense given a bank's particular needs.

Leveraging Business Analytics to Gain Strategic Intelligence

To identify the most fertile areas for new or enhanced revenue generation opportunities, cost reduction and profitability, use of strategic and business analytics is imperative. For example, on the revenue side, marketing analytics can provide a means to better farm an existing customer base and, combined with external market data, hunt for new clients utilizing sophisticated predictive and behavioral models on buying and usage trends and habits. On the expense side, analytics have been an important formula in measuring risk, determining the appropriate level of risk in banks' credit portfolios and controlling loan losses. The financial crisis drove home the importance of these metrics and the gaps that existed with current risk management systems and processes. These analytical capabilities can lead to numerous opportunities in balance scorecard development, data analysis and revenue-prediction generation.

Cost Reduction and Outsourcing

Banks have been facing, and continue to face, choppy waters related to the economic downturn and regulatory actions. This has heightened the need to find new sources of revenue while also continuing to manage down costs in line with reduced revenue. This article has provided a brief overview of what some institutions are doing to address these issues. Additionally, it has highlighted three specific areas that Hitachi Consulting believes present opportunities for addressing some of the revenue and cost challenges facing banks. We welcome the opportunity to discuss these further.

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