THE BANKERS' CHALLENGE OF SUSTAINABLE REVENUE GROWTH IN VOLATILITY

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1.0 Introduction

The financial crises of 2007–2009, followed by 2011 sovereign debt crises in the USA and the European Union, exposed the underlying weaknesses of the seemingly low-risk, high-return banking model that had dominated many western markets through the mid-2000's. As a result, the financial conditions and banking operations across the globe became highly volatile and uncertain. For example, many banks noticed their customers becoming more volatile in their relationships and more sophisticated in their buying behavior. The perceived breach of trust revealed by the recent financial crises, made customers more open to offers from new providers other than banks. The mobile providers and new communication channels/social media were changing expectations on how services are provided and consumed. This emerging customer behavior was having a direct, negative impact on the profitability of banks, with almost half of the banks experiencing a noticeable drop in their customer profitability.

Though it appears that the recent crises are passing through without a serious collapse in the global banking and financial sector, the changes have led to increased volatility and additional challenges to the banking environment. In other words, the crises have made the sustainable revenue growth and innovation of the banks more challenging. In order to achieve a sustainable revenue growth, banks must simultaneously be able to generate profits today and have a plan to grow revenues in the long run. Further, innovation plays a critical role in banks' sustainable revenue growth, by differentiating their products and services in the highly competitive banking environment. Banks affected by the financial crises in the recent past have struggled to grow revenues consistently. However, in the current environment emerging in the wake of the crises, banks in the growth markets such as USA and the EU have shown an improvement in stability and are returning to moderate profitability leading to sustainable revenue growth in the future.

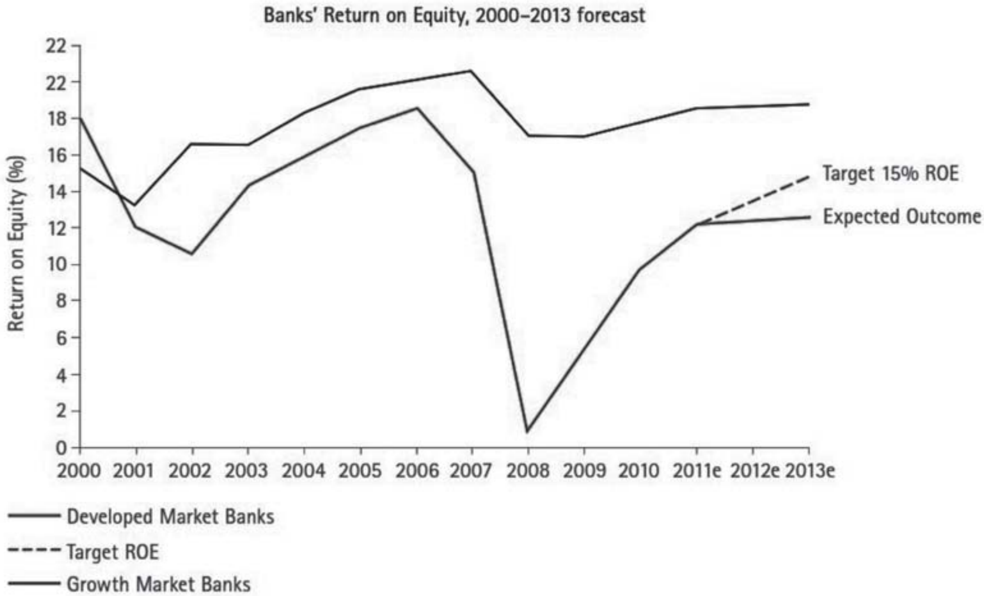
This article focuses on a recent global research (Accenture's Banking 2012 Research) conducted in the USA and EU over the past three years. The study examined the basic levers that increase banking profitability and the operating models required to deliver sustainable profitability in the new challenging environment in the above markets. The research revealed that since the economic downturn, banks in most growth markets have achieved consistent profitable returns which are almost at the pre-crises levels. Further, it identified the banks that have outperformed their peers over the last three years and the critical factors for their excellent performance. It showed that to enable sustainable revenue growth, the banks need to restructure their cost base, improve risk and pricing capabilities, and significantly improve their management of customer relationship. It has been also identified that in some markets the best performing banks have substantially outperformed their peers through a combination of their business strengths and operating models. The above research found that the best performing banks exhibit excellence in five areas which were often intertwined. Namely, employee productivity, customer relationships, cost-to-serve, risk management and innovation. The recommendations of this study are considered vital for banks in developing volatile markets, to face challenges in sustainability in revenue growth. This article will highlight key areas of the above study and its recommendations, for sustainable revenue growth and innovation in a volatile environment.

2.0 Increasing Challenges in Revenue Growth in a Volatile market

In the emerging environment following the recent financial crises, banks in North America and Europe recovered a degree of stability and return to moderate profitability. The economic tailwinds driving growth in many banking sectors in the developing market have helped them in this process, and many of the developing markets are now home to a number of the world's largest banks. However, strong headwinds in the new environment pose serious challenges to the banks, as they seek to attract much-needed capital and deliver a strong return on equity to investors. The changes demanded by banking stakeholders are most obvious in this regard, as the public, governments and regulators require that the recovery must be sustainable and such turmoil is never to be repeated.

The above study identified the banks that have been able to outperform their competitors over the last three years in revenue growth and superior returns on equity. By delivering superior results, they ensure a market premium for their future growth potential. The following Figure 1 shows the large banks' Return on Equity (ROE) development 2000 – 2013 forecast in Europe and North American countries hit by the above crises.

Figure 1: Large Banks ROE Development and Forecast



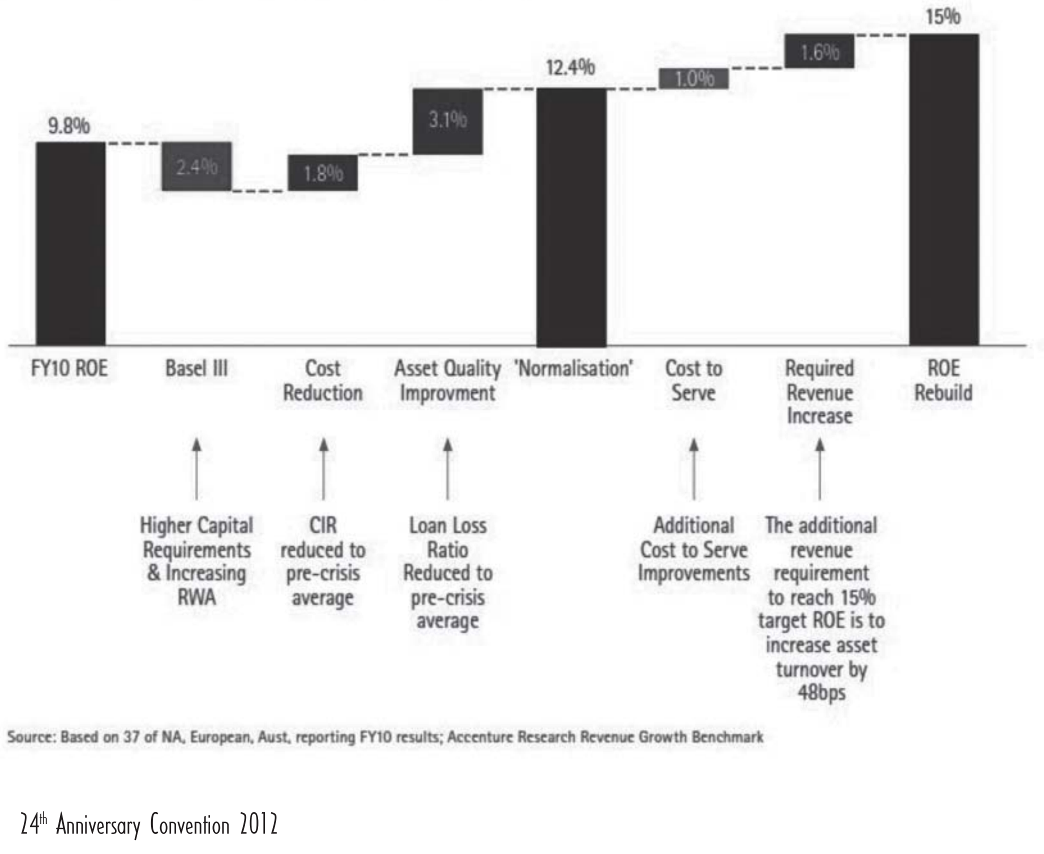
Notes: Accenture Research, based on Bloomberg data for average ROE for 120 largest global banks by market cap; Consensus analyst estimates for 2011 forward.

Many of the superior performers were from high-growth markets which were less affected by the financial crises and some banks in crisis-hit markets also stood out in their performances. Further, all banks have not been able to make higher levels of growth in emerging markets. However, valuable lessons can be drawn from both, fast- and slow-growth environments to gain insights into what banks can do to achieve superior revenue growth. Up to the crisis in 2008, the 'cheap-money high leverage' banking model that delivered high returns and low risks was operative in the above banking environment. Top performing banks in Europe and North America were delivering very high and unsustainable level of ROEs over 25%. But with the effects of the crises, the ROEs of banks in developed markets dipped to about 4% through 2008 – 2009, as a result of liquidity being drying up, economies being soured and risks affecting their Balance Sheets. However, by 2010 the average profitability of these banks recovered to a ROE of about 10%, as the immediate crises had passed. During the recovery phase in mature economies, many banks restructured operations and raised capital in order to achieve ROE levels of about 15%. As indicated in Figure 1, banks in most growth markets showed more consistent, profitable returns in 2010 with average ROEs about 18%, dipped only marginally from their pre-crisis levels. The research indicates that the target of achieving high ROE levels could only be achieved through significant restructuring of the cost base, improved risk and pricing capabilities and most critically, improvements in banks managing customer relationships.

However, the low business volumes, rising funding costs, increased regulatory costs of higher capital levels and liquidity buffers, have added to banks' caution in predicting the size of the recovery of their ROEs. Further, at a more global level, concerns over the sustainability of economic recovery in many countries and downside risks, such as the European sovereign debt issue have also added to the banks' challenges. As funding and capital continue to weigh against profits, even with all the above restructuring plans and improvements in asset quality, the study revealed that the banks' ROE will rise only up to about 12.6% by 2013 (Figure 1). Therefore, the banks' corporate management teams are faced with major challenges to meet the expectations of the stake holders and avoid being classified as a low-return, 'utility' industry.

As some traditional routes to higher profitability such as increasing leverage ratios are no longer available, banks in the above post-crisis environment have introduced many other management actions to exceed market expectations and deliver higher levels of sustainable ROEs . Analysis based on 37 of North American, European and Australian largest banks' reporting FY 2010 results and Accenture Research revenue growth benchmarks, have identified the following effects in the said banks' Post-tax ROE development, 2000 – 2013 forecast, (Figure 2).

Figure 2: Developed Market Banks Post-Tax ROE Development



Source: Based on 37 of NA, European, Aust, reporting FY10 results; Accenture Research Revenue Growth Benchmark

As shown in Figure 2 above, the Post-tax ROE of the Banks for FY 2010 was 9.8% and the forecasted higher level of same for 2013 is 15%. Above analysis shows that FY 2010 Post-tax ROE of 9.8% would :

- depress by 2.4% due to the increasing capital levels and risk weightings required to meet the estimated Basel III levels.
- improve by 1.8% as a result of the reducing cost Income ratios to pre-crisis level.
- improve by 3.1% as a result of the normalization (ROE 12.4% level) of asset quality to the average pre-crisis level.
- Improve by 1.0 % due to cost-to-serve improvements
- Improve by 1.6% with the additional revenue generated, through the increase of Asset Turnover by 48bps, to reach the forecasted Post-tax ROE level of 15% by 2013.

Analysis of the above study suggests that the following two fundamental profitability measures to banks, to achieve superior ROEs in a post-crisis, volatile market environment.

i. <u>To reduce the Cost/Income ratio</u> : As majority of the banks' cost base lies in distribution, the banks need to address the cost of serving their customers to achieve high ROE growth.

ii. <u>To increase the yield on average earning</u> : Banks need to grow revenue profitably to achieve higher ROEs. This fundamental measure is critical to banks for sustainable growth. This is a major challenge in a volatile market, as the interest margins are under pressure from lower business volumes, rising funding costs, low interest rates, regulatory intervention and fee income being challenged by stiff competition.

However, the study confirms that the best performers in some markets were able to outperform their peers by substantial margin, through combined strengths of their businesses and operating models. How have they done this and what insights the banks in developing economies can draw from these lessons ? The following text highlights the main ideas and recommendations of the above study to answer this question.

3.0 Generating Sustainable Revenue Growth

The analysis of the above study reveals that banks in developed markets in the EU and US affected by the crises have struggled to grow revenues consistently over the past three years. The crises have led to increased volatility and difficult marketing conditions, specially in business areas such as investment banking, commercial property and mortgages. However, many banks in the growth markets in these geographies have been much more resilient, increasing revenue growth over 20% per annum, driven mainly by credit expansion. Large mergers have also contributed to generate future revenue growth for many larger banks in these markets. It revealed that the high performing banks grew revenue profitably and sustainably over time, and they have been rewarded with higher market ratings and valuations such as future market growth values.

The above research identifies a number of shared characteristics among high performing banks across different markets in the above developed countries. These characteristics have differentiated themselves from low performing banks in consistent revenue growth. The shared characteristics of the high performing banks were : superior earnings quality, lower earnings risk, access to superior growth markets, and in some cases a combination of the above factors. Out of the above four salient features, 'superior earnings quality' was identified as the key characteristic in a bank that generates sustainable revenue growth. These banks were able to generate higher asset turnover over time or earnings at a higher margin, due to underlying operational efficiency.

In addition to the above salient characteristics, four key financial ratios were identified by the researchers in these high performing banks in developed and emerging markets. The analysis was based on the Bloomberg data for Average ROE for FY 2010 of 120 large global banks in the USA, Canada, Europe, UK, Australia, Brazil and Turkey. As a result of focusing on the following key financial ratios, the above banks were able to generate higher asset turnover over time or generate earnings at a high margin and display superior earnings quality due to operational efficiency.

Key financial ratios identified in high-performing banks in developed and emerging markets :

i. *Asset Turnover on Earnings Assets* : Net Operating Income/Interest Earnings Assets
This is the amount of income generated per asset value (unit currency) and it measurers how efficiently the company uses its assets for income generation.

ii. *Cost-Income Ratio* : Operating Costs/Net Operating Income
This ratio measurers a company's Cost efficiency.

iii. *Loan Loss Ratio :* Loan Loss Provision/Net Operating Income
This is a key measure of the level of risk in the bank's loan portfolio

iv. *Return on Equity* : Net Income/Equity Capital
This ratio capturers the return on investment provided by the financial institutions' common equity investors after tax.

The high-performing banks in the above economies achieved superior earnings quality due to :

a) <u>High Asset Turnover</u>
Banks in growth markets achieved high asset turnover mainly through wide margins and spreads on their core lending and deposit business or holding of high-yielding domestic bonds. However, their earnings potential were frequently impacted by poor asset quality and low levels of leverage requested to operate in less stable financial markets.

In contrast, banks operating in developed markets, who experienced much tighter spreads, adopted various different business models and strategies to achieve this target. For example, customer-centric models that focus on high-level of customer value and substantial cross-sell were able to generate high interest and fee income, very often displayed long-term outperformance. Further, strong customer-centric models that generated solid interest and fee income were combined with other business strategies to achieve high asset turnover.

Further, number of international banks have built-up mixed portfolios that spans high-margin growth markets, combined with low-return developed markets. This combination enabled these banks to deliver a stronger return on assets than their peers.

b) Operational Efficiency

As a result of adopting following strategies, a number of banks and banking markets outperformed their peers in operational efficiency.

Leveraging IT systems, efficient back office processing, low-cost distribution techniques, capitalizing on global operations and IT models to develop highly efficient global networks, helped them to become most efficient banks in the world.

c) Low earnings risk

In addition to earning high quality sustainable income, focusing on lower risk businesses or markets is vital for banks to earn higher market premium. The analysis revealed, the banks that have a higher weighting towards non-lending business activities and solid long-term customer relationships, outperformed the market in terms of asset quality and suffer less impact from the financial crises. For example, in North America some large banks demonstrated more stable earnings through their solid Assets and Wealth Management business, while in Europe some banks outperformed their peers by focusing on their long-term corporate relationships during the economic downturn.

Further, banks operating in well-regulated markets that did not suffer from the pre-crisis drop in lending standards (eg. Australian, Canadian), has been successful in sustaining high ROEs during the crises without much structural impact. They were able to operate with higher degree of leverage, without very high impact of higher loan losses and write-downs.

d) Superior market growth potential

As the economic prospects have noticeably shifted more towards the developing markets, the study identified that many banks operating in these fast-growing economies have benefited from a market premium. The banks that have been able to outperform the growth rate of the market as a whole, have demonstrated an increase in their market premium. For example, some banks in Brazil and Turkey have been able to expand their line of business, acquire new customers, and grow assets faster and more profitably than most of their domestic competitors.

4.0 High Performing Banks : Measurers of Revenue Sustainability

The key to success in business is to generate sustainable profits, with a credible plan to grow revenue in the long-run. Many banks find this a tough challenge, after recovering from financial crises that prevailed over the past five years. As discussed above, how high performing banks in various markets have delivered superior revenue growth during the economic down-turn, has given valuable insights into critical revenue growth measurers.

The analysis identified the following five core performance factors in these high-performing banks, where they used to outperform their peers.

i. *Employee Productivity* : the contribution from the employee towards sustainable revenue growth or the ability of staff to generate sales, acquire deposits and earn revenue for the bank.

ii. *Customer Relationships* : the quality of services and relationship between the bank and its customers. The measure is very often expressed in service quality matrices and the share of customer's business, both in terms of share of value, cross-sell and the attrition level.

Iii *Cost-to-serve* : the overall cost of serving the customer, including distribution, efficiency and the use of multiple channels to provide services.

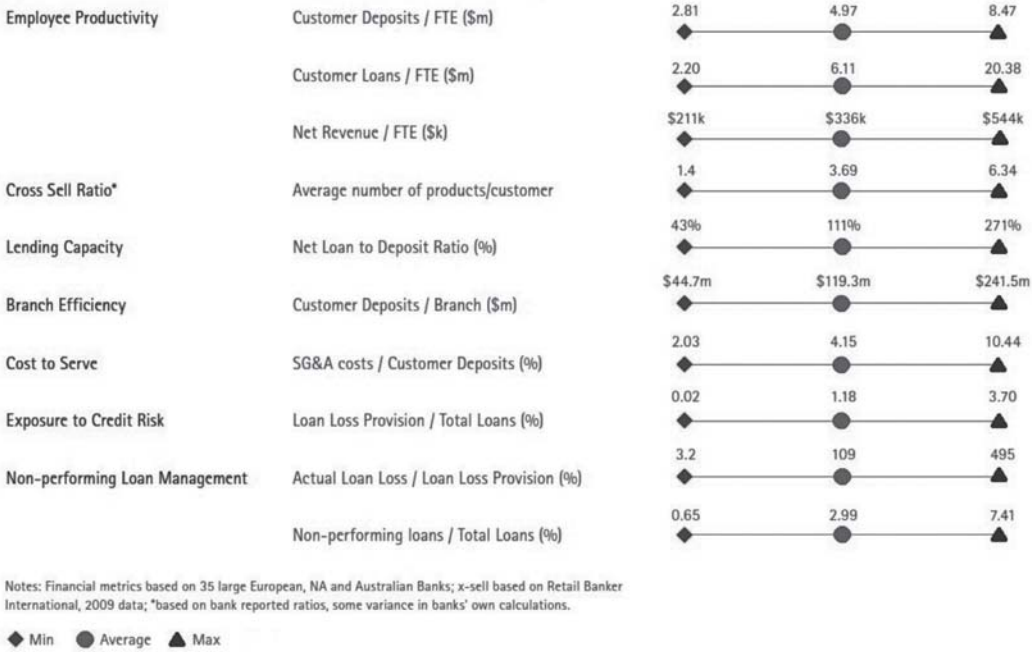
iii. *Risk Management and Innovation* : the rate of non-performing loans, and the ability to recover outstanding loans.

iv. *Innovation* : the use of technology and new business models to engage and extend relationships with customers, including on-line, mobile and social technologies.

In the analysis of high-performing banks it was noted that most of the above critical factors are inter-related. For example, banks with well-developed customer relationship models devote more of their employees time to promote sales and services to win a greater share of the market. Further, many high performers maximized their customer reach by increasing the use of their efficient direct and multi-channel distribution systems.

Figure 3 below shows the operational KPIs used to monitor and optimize revenue growth of the high performing banks in the above developed markets. They will help banks in developing markets to draw valuable insights into designing their own KPIs, in order to monitor and increase their revenue growth.

Figure 3: Selected Revenue Growth Operational Levers – Developed market banks



5.0 Sustainable Revenue Growth : Successful Service Models

The strategic direction and growth models adopted by the leading high performing banks around the world was closely examined by the researchers. It was revealed that most of the banks were focused on one of the two following dominant servicing models :

i) Developing and growing the core retail relationship banking business OR

ii) Expanding the geographic scope or business scope within which the banks operate.

The two models effectively encapsulate one of the two main ideas : increasing the value of the customer value proposition and growing the business franchise to capture new growth. Each model requires different capabilities and competencies and the risk of delivering "just enough to fail" in these two models were very common. However, the high performing banks avoided this risk by selecting distinct geographies or brands for each strategy, such as developing customer-centric strategy in a domestic markets, while focusing on a growth acquisition model in foreign markets. The majority of high performing banks' success was built on a dominant focus on one or the other of the above distinct growth directions.

6. Growth considerations for banks in a post-crisis volatile market

As a result of the recent financial crises, the growth landscape of banks over the world has changed and the operating environments have become more volatile. The current post-crisis market conditions demand that banks take in to account the following challenges, which have implications on the development of their growth models.

i. *Capital Efficiency and Risk* : Due to the rise in capital levels and increase in the Cost of Capital, banks must ensure that they conserve capital levels and are able to earn above their Cost of Capital.

ii. *Liquidity and funding* : New liquidity rules and higher wholesale funding costs adapted by banks, compel them to compete for more deposit funding and lengthen maturity profiles. These issues impact on how banks choose to grow margins and decisions such as whether there are sufficient deposit pools in home markets or there is a need to look at new markets.

iii. *Sustainability of revenues* : The lessons from the recent financial crises compel banks to ensure that they are accessing revenue pools that offer long-term growth.

iv. *Innovations* : With the development of new technologies, banks need to find new ways to deliver their products and services and connect with customers, to capture more of their business models. However, as banks and non-banks alike leverage new technologies and customers too adopt new technologies and behaviours, this has become a major challenge for the banks.

7. Conclusion

Banks operating in developed, as well as in emerging markets in this post-crises volatile environment face many challenges in generating profits to maintain sustainable revenue growth Based on the above study, the optimal path to sustainable revenue growth is highlighted as follows.

Optimal path to growth for any bank is highly dependent on a combination of market factors:

- Maturity of home markets
- How regulations and the economy will impact growth prospects
- Bank's internal factors such as current strengths, business model and capabilities

Further, taking above facts into consideration, banks need to select between two growth directions :

(i) Increasing customer value OR

(ii) Business expansion

To execute on either of the above strategies, banks need to :

- Set a clear vision that will guide the bank to determine the interventions, business model and capabilities that need to develop
- Focus on building the right capabilities to ensure delivery against their chosen model (avoid the distraction of investing outside the bank's growth path)
- Reach clear decisions on where and how to innovate to support the goals of their growth strategy, against the volatile business.

In conclusion, Accenture's analysis of the growth strategies and underlying performance factors of high performing business models over the world, has shed light on the banking industry. These insights can help banks in any market place to clarify what they need to do to define a growth plan, and then to determine how to deliver it to achieve the goal of sustainable revenue growth.

References :

1) "Banking 2012 : Revenue Growth and Innovation" by Accenture Research, USA

2) www.accenture.com