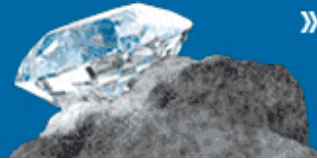


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FINANCIAL NEWS



Banks must rethink their strategies

Roy C Smith

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The “Swiss Finish” that adds a 5% topping to [Basel III](#) Tier-1 rules and 9% of contingent capital will require UBS and Credit Suisse to hold capital equal to 19% of risk-weighted assets by 2019. One might have thought that with more than 16% Tier-1 capital ratios, these banks would easily be able to meet any enhanced requirements Swiss authorities might decide to finish up with.

But after Basel III’s tougher definition of both capital and risk-weighting, and the extra bits about leverage and liquidity, that will not be the case.

Both banks will have to “mitigate” exposures (further deleverage), cut costs (downsize) and accumulate new capital (by deferring dividends) to comply. The UK is apparently considering something similar for its banks, and Dodd-Frank is out there too – the real costs of being subject to its “enhanced” requirements for systemically important institutions is still unknown, but it is likely to involve a similar step up.

Goldman Sachs’s chief executive Lloyd Blankfein made headlines recently by telling a panel in Brussels that banks could move their operations, people and capital and would do so if the new regulations created large disparities between regions. What Blankfein did not say is that the big banks may have to change their businesses, not just move them.

Most large banks have followed a business model based on two ideas: that banks should have large balance sheets to enable competitive positioning of risks to secure the most profitable client mandates; and they should maintain multiple revenue platforms and cross-sell between them as much as possible.

Banks have been able to add size and business lines through mergers and use leverage to fund trading positions, but now they will be restrained from doing either. The new rules, which are likely to be more even across regions than Blankfein expects, will bring down shareholder returns, perhaps, according to some sources, by as much as half, or scarcely more than their cost of capital.

Markets are already reflecting such an outlook in the securities prices of the major banks. A look at

the top 12 global banking players (in terms of market value and capital market activity) reveals the following: their average stock price-to-book value at June 30, 2010 was 1.0, thereby valuing their management teams and business franchises at virtually nothing. Their average return on equity for the first half of 2010 (10.4%) was less than their average cost of capital (11.0%), so their economic value-added was less than zero.

Excluding the three banks most beaten down by the stock market ([Citigroup](#), Bank of America Merrill Lynch and [Barclays](#), which all trade well below book value), the average market-to-book ratio only rises to 1.15x and the net economic value-added to 3.0%. But these figures are far below two to three times book value, and 8% to 10% economic value-added, posted by many of these banks before 2007. Their stock price earnings and market-to-book ratios are lower than smaller, less broadly diversified firms, which are easier to manage and impose less systemic risk.

The market seems to be saying that even after economic recovery, the expected added costs of the new risk-reducing regulatory regime renders the old business model obsolete.

The time has come for the large banks to re-examine the different businesses they are in, and the size of their commitments to them, so as to determine some sort of optimal business combination under the regulatory conditions that are about to envelop them.

They are to be subject to substantially enhanced capital and other requirements that their smaller competitors are not.

Over the years, academic studies have found no economies of super-scale in banking, nor could they find economies of scope, after all the costs of cross-selling were considered. What they did find was a “conglomerate discount” for some of the largest banks with market prices less than their break-up values. These discounts have existed for years, but managers and some bank stock analysts have defended the strategies with their dominating market shares and the excitement of power-enhancing merger announcements.

But the markets aren't buying it today, and boardrooms seem to know it. Restructuring is in the air. Citigroup is trying to rid itself of its past mistakes by selling off Citi Holdings (once worth 40% of the group's assets). Morgan Stanley recently made a major commitment to becoming the world's leading retail brokerage – but does it need a sophisticated, globalised investment bank to do so?

Goldman Sachs is unloading its proprietary trading business. Should it also spin off its private equity and hedge fund activities into a new, non-banking vehicle not subject to enhanced regulation? Maybe UBS and Credit Suisse ought to combine their investment banking businesses, which have caused them so much misery over the years, into a new firm and spin it off to their shareholders so they could focus on shoring up their hugely valuable but battered private banking businesses. Deutsche Bank might buy them if it could get rid of its lacklustre German retail business. Now that it sees what's ahead, will Barclays still want to bet on the third reincarnation of Lehman Brothers, or Bank of America on Merrill Lynch?

In the 1980s, most of the largest banks in the US and Europe went through strategic realignments – back to basics, slimming down and refocusing – in order to improve operating results and shareholder value. In the late 1990s they departed from this path to take up big balance sheet investment banking, which has proved costly. Tougher bank capital and other regulations will force another, similar strategic realignment, with the new paradigm being just what the old one was – going back to basics, slimming down and refocusing.

- Roy C Smith is professor of international business at NYU Stern School of Business

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