Financial services’ shifting profit pools

By Andrew Schwedel and Antonio Rodrigues

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Financial services companies have spent a long, turbulent spell wrestling with the huge credit and liquidity challenges that have rocked the sector. They’ve skirted insolvency, survived vertiginous drops in asset prices, raised fresh capital and adapted to tough government oversight. Unfortunately, much more work remains to be done.

Despite recent rallies by some commercial and investment banks, the industry’s structural profit pools have shifted, with little sign that they will return to precrisis levels anytime soon. The sector, which nearly doubled its share of gross domestic product (GDP) between 1980 and 2007, now faces a major contraction, as industry returns will lag over the next several years. Based on Bain & Company analysis, profits shranked to $17 billion in 2008, from an annual average of $430 billion between 2004 and 2007. (See Figure 1.) While the industry is likely to rebound in 2009, it won’t regain precrisis levels until 2013.

As they struggle to find their footing amid continued economic turbulence, all three major sectors of the financial services industry—banks, insurers and investment houses—will remain hobbled by the legacies of past business practices. How the contraction plays out across each sector, or affects any particular company, will be determined by the changed behavior of customers battered by the downturn and how nimbly the financial service leaders respond.

Figure 1: Sector profits will not return to historic levels until 2013

Note: Average (excluding capital markets)
But at least for the next few years the outlook is sobering. According to a Bain & Company analysis, banking returns on equity will not return to their 2006 peak until at least 2013, as further credit losses mount. Bain calculates that the sector is likely to earn at least $200 billion less than its cost of capital over the next five years—a gap that could widen if the recession lingers. Insurers face an overhang of guarantees on annuity and life insurance policies they have underwritten, leading to a sharp increase in unrealized losses. Bain estimates that insurers will need to add some $65 billion in new capital to restore the sector’s equity-to-asset ratio to 2007 levels. Profits in retail asset management will remain below their cyclical peak through 2013, as values gradually recover.

Companies will also confront a tougher new regulatory landscape that will close off some of their paths to restore earnings and require them to invest in good scenario planning. Though specifics are still uncertain, lenders will almost surely face new consumer disclosure rules, caps on fees and limits on securitization that will significantly crimp their profitability. They will also be required to raise fresh capital—an additional $200 billion on top of the $390 billion the big U.S. banks raised over the past year, according to Bain’s calculations—which will reduce their returns on equity. Such big changes will force banks to reassess their current business models. For example, new rules that will dramatically cut back overdraft fees will call into question the basic economics behind the popular “free” checking account model that has dominated retail banking for better than a decade.

Climbing out of this hole will challenge financial service companies fundamentally to retool three key elements of their businesses where they retain critical room to maneuver.

**Customers: Meet the new, new investor class**

As recently as early 2008, U.S. households were sitting on huge home-equity appreciation, had retirement nest eggs swollen by stock market gains and kept their broker’s cell phone number on speed-dial. Dubbed the “new investor class” for their enthusiastic accumulation of financial assets, they embraced investment risks, eagerly topped up on credit and were willing to pay premium commissions and fees to financial service providers who promised market-beating returns.

As they ponder their post-crisis future, financial services companies need to reckon with customers whose assets are depleted, worried about job security and weighted down by debt. The financial crisis has fundamentally changed their views of investing, tempered their tolerance for risk and diminished their expectations for investment returns.

The new, new investor class’s chief objectives will be to pay down debt and rebuild cash reserves. But even as their savings rate rises (from just one percent in 2007 to some 7 percent, by Bain’s calculation), the net flow of household income into financial assets will be some 20 percent lower on average through 2013 than they were during the flush years from 2004 to 2008. (See Figure 2.) This year, Bain forecasts that total flows will plunge to $390 billion, from $800 billion in 2007. Given the very shaky balance sheets of middle-income households, the bulk of these flows will come from high-net-worth customers. As investment flows contract, financial service providers will need to wage a high-stakes battle to attract and retain the smaller population of wealthier clients whose balance sheets have held up best.
To attract their share of investors’ dollars, financial service companies will need to shift their mix of product offerings away from volatile investment funds and other asset classes that offered high returns but required investors to assume more risk. While reducing debt loads will be a top priority for most customers, even investors who remain open to shouldering risk to rebuild wealth will be looking for simpler, lower-cost vehicles that provide greater liquidity, like stock index funds and exchange-traded funds, or greater safety, like fixed-income annuities.

In the wake of the credit and stock market meltdown that so undermined their credibility, financial service providers will need to take customer loyalty seriously. They have a lot of ground to make up to regain customers’ trust. Using a measurement called Net Promoter® Score (NPS) that Bain & Company codeveloped with Satmetrix, a customer-experience software firm, we have tracked trends in customer loyalty at scores of financial services companies over the past five years.

With disgruntled customers looking for new, low-cost ways to save and invest and increasingly open to switching service providers, the potential prize is huge. Our work across 13 industries in 24 countries has found that companies that are loyalty leaders capture a higher proportion of sales from customers who trust them. They also experience lower levels of customer churn, which holds down marketing costs. Their loyal customers, too, are also more willing to recommend them to like-minded friends and colleagues who are apt to become loyalists themselves.

When Bain last surveyed customers of financial service providers in mid-2009, NPS for the sector overall had sunk to all-time lows from where they had been the previous spring as they absorbed the harsh realities of the cratering credit and security markets. (See Figure 3.) The volatile scores suggest that customer relationships are in play and that firms that excel as loyalty leaders can make significant market share gains. They also point to distinct pockets of opportunity for some institutions. Specifically, scores for
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Figure 3: Industry turmoil has put customers “in play”

![Retail bank client Net Promoter® Score chart]

Source: Bain retail banking survey

regional banks have held up far better than those of the troubled big banks. Among brokerage firms, the traditional high-cost wire-houses have lost significant ground to the independent broker dealers that have worked to position themselves with investors as value-oriented trusted advisers.

The brokerage firm Charles Schwab is seizing the advantages of loyalty leadership to pull away from the competition during the downturn. Over the past five years, the company has driven disciplines of customer focus deep into the organization, empowering branch office staff to convert clients into advocates and holding them accountable for results. Schwab is beginning to reap the rewards of that patient investment. In a year when retail investors were pulling money out of tumbling markets, the brokerage business grew by $113 billion, as the company posted record operating profits.

Costs: Rethink the business model for deep savings

As revenues rose sharply with economic expansion through the end of 2007, banks, insurers and asset managers felt little pressure to hold down operating expenses. But with customers more price sensitive than ever and profit margins squeezed, they need to dig in much deeper to bring down costs.

They have a long way to go. To restore 2011 returns to 2007 levels, for example, life insurers and asset managers will need to find some $15 billion in cost savings, according to Bain’s analysis. Among banks, the cost savings have not kept up with shrinking interest and fee income or with the big jump in provisions they have been forced to make to absorb losses on nonperforming loans. They will need to lower costs by $45 billion by 2012 to regain returns on equity that prevailed in 2007.
For the financial services sector as a whole, cost reductions on the order of 9 percent to 15 percent will be needed to bring costs in line with lower revenues. Much progress has been made, but there is still a long way to go.

Conventional approaches are apt to fall short. As they enter a period of higher capital costs, more stringent regulatory oversight and pinched profit margins, companies will need to rethink their business models to succeed. By homing in on core business activities where they can exploit competitive advantages, tomorrow's winners will burrow deep into their organizations to identify and strip out the product, process and organizational complexity embedded in their businesses.

The cost of complexity was especially insidious for financial services companies during the past expansion, in part because it was all but invisible and grew without restraint. Companies slipped into a trap of adding products and services that piggybacked on existing offerings and modestly increased customer support to serve the new accounts. But the apparently low incremental costs proved deceptive because they masked the steep, hidden systemic costs that built up in underlying processes. Now, with customers' appetite for variety sated, many financial service providers find themselves struggling with a huge overhang of complexity and all its costly consequences.

What to do? Cutting structural costs deeply while simultaneously strengthening customer loyalty is a big challenge for any company to pull off. Trying to root out complexity by paring back on product offerings or shutting down business lines, for example, does not eliminate the need to continue to serve accounts held by legions of legacy customers. But the challenge is far harder for financial services organizations that continue to add complexity, as many are still doing in response to market pressure to reduce their perceived risk by diversifying. In fact, what's called for in today's straitened times is to focus clearly on the few competitive battlefields where the company determines it is best able to compete.

Service companies that succeed in tackling complexity start with a blank sheet of paper. They begin by calculating what their cost structure would look like if they were to offer just one product—the stripped-down “Model T” approach. Then, they cost out each new product variant as new features are added back in. Companies that put themselves through this exercise typically find that costs do not rise in a linear fashion but rather jump sharply at break points where added complexity starts to strain against capacity. Knowing where those break points occur—and how to avoid them—can spell the difference between healthy profitable growth and subpar performance.

Some pioneering banks in Europe and in fast-growing emerging markets are putting this insight to work by fundamentally rethinking how to operate their branch networks more like retailers to boost customer traffic and radically reduce costs. Applying a concept we call light-retail banking, they are stripping branches of costly transaction-processing activities, shrinking their footprint and converting branches into attractive boutiques that focus on product sales. Construction and operating costs for a compact bank “store” are less than one-quarter of those of a standard branch. Several U.S. retail banks have begun applying light-retail principles to their branch networks, but most still need to integrate the approach more completely with the services they offer online and with their back-office customer-support operations to achieve the full potential of the new approach.
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The second critical step for wringing out complexity is to zero in on what customers truly value. Working with clients from a variety of industries, Bain has discovered that typically 5 percent of a company’s products can account for up to 95 percent of its sales.

Finally, organizations determined to steer clear of complexity remain perpetually vigilant. Customers and competitors don’t stand still, and as financial service companies race to innovate, the likelihood is high that complexity will creep back in. Smart companies avoid this by putting safeguards in place to keep their business model simple. They raise the hurdle rate any new product or service must clear before it is added to the portfolio. And they “prune the garden” by eliminating or streamlining an existing product when a new product is added.

Capital management: Recognize how risk affects profitability

The fundamental blind spot at the heart of the financial services sector meltdown has been an institutional and systemic failure to assess risks properly and put safeguards in place to control them. Poor risk management led banks and other financial companies to miscalculate their true profitability and, as a consequence, to commit scarce capital to developing and marketing the wrong products, and using the wrong incentives to reward “success.”

For many companies, the source of the problem has been to run their businesses paying insufficient attention to their true risk-adjusted economic profits. Economic profit begins with the net after-tax accounting profit but then critically adjusts for the amount and cost of the equity the company commits to put at risk. Thus, when measured on a risk-adjusted basis, the economic profits associated with a given product, customer segment or market will likely be significantly lower than accounting profits—potentially turning an activity that appears to kick off healthy profits into a money loser.

While the big financials services companies did try to account for risk and capital costs in the period leading up to the credit meltdown, most failed to factor it appropriately into their decision-making processes. In some cases, information remained bottled up in the finance department and did not reach business-unit heads who tried to optimize gross revenues or other performance measures. In other instances, they may have made their estimations based on faulty assumptions. For example, banks did recognize the need to adjust for risk the capital they committed to underwriting mortgages, but their formulas massively underestimated how big that risk could be in a scenario where housing prices collapsed nationally, leading homeowners to default in unprecedented numbers.

Clearly, a more realistic appraisal of risk and a more integrated approach to managing capital needs to play a much more prominent role in today’s more sober times. As they recalibrate their expectations going forward, for example, financial service companies are taking a renewed interest in attracting plain-vanilla deposits as a surer source of stable funds to support long-term asset growth.

Financial services companies that respond to the painful shift in profit pools by taking on the hard work to strengthen bonds of trust with loyal, more parsimonious, customers, squeeze complexity out of their core businesses and do a smarter job of managing scarce capital may not get the quick earnings kick the sector once enjoyed through leverage and by embracing risk. But they will surely earn a sustainable competitive edge that their less focused rivals cannot match.
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How we do it

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