

Bank specialization  
New strategies,  
new risks?



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# Strategic choices

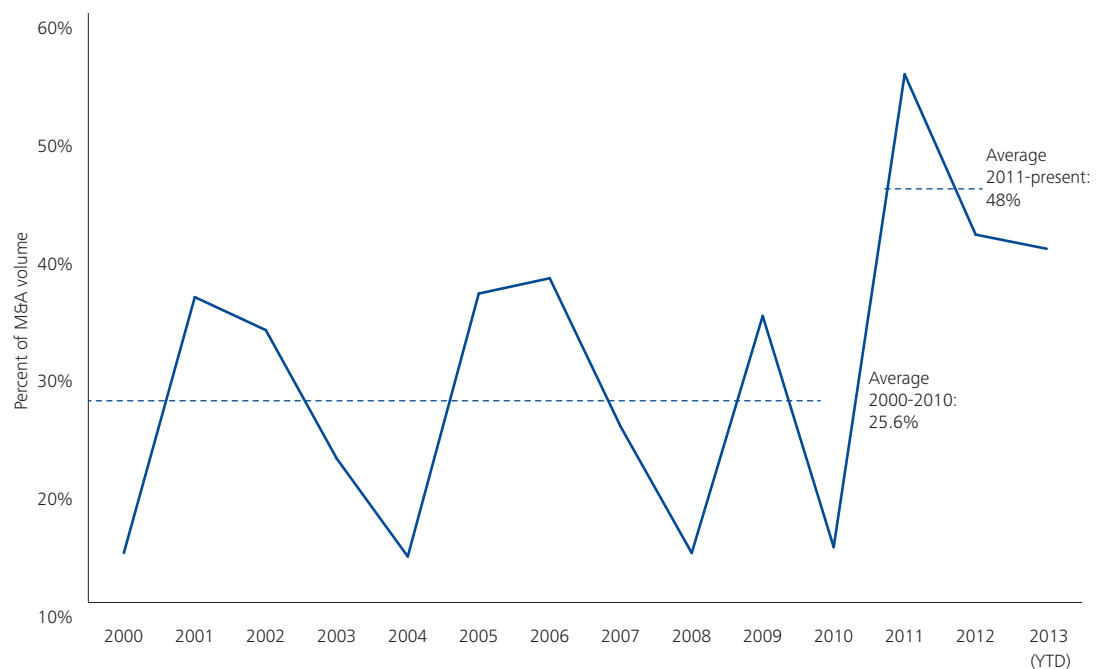
Driven by difficult market conditions, concerns about complexity, and new regulation, many banks are making tough strategic choices. While “too big to fail” and other related issues may be grabbing headlines as stakeholders debate the ideal structure of the industry, there are significant strategic decisions being made in the industry now. As a recent article in *The Economist* pointed out, “banks are shrinking their balance-sheets, retreating from foreign operations and closing businesses. This is dramatically reshaping the industry.”<sup>1</sup> These changes may bring major benefits, but could also carry substantial risks.

In many cases, banks are making changes that may result in a sharper focus on a select set of “core” businesses. In other words, they are specializing.

In doing so, banks are changing long-held strategic priorities. For decades, many U.S. and global banks have been expanding their operations across geographies, business lines, and customer groups. This portfolio diversification promised many benefits: boosting growth by adding emerging sectors to mature ones, strengthening customer relationships through complementary products, and capturing cost efficiencies flowing from diversity.

But the turmoil of the last few years has caused many banks to rethink this logic. Some firms have already begun to act. Anecdotal evidence of this fact is supported by the data: Divestitures of operating units and asset portfolios—one likely indicator of specialization—have accounted for between 40 and 55 percent of mergers and acquisitions (M&A) activity for the last two years, almost double the 2000-2010 average of 26 percent (Figure 1).<sup>2</sup>

**Figure 1. Divestitures as a proportion of all financial sector M&A activity**



Source: Thomson Reuters. Data as of June 2013.

# Drivers of the change

Alongside performance pressures, regulation plays a large role in banks' strategic shift.

Basel III-inspired capital provisions, while yet to be fully implemented, are perhaps the most significant driver of specialization. Higher capital requirements and more stringent risk-weighting rules have forced banks to make hard choices about where they compete.<sup>3</sup>

In the United States, the Dodd-Frank Wall Street Reform and Consumer Protection Act<sup>4</sup> has forced the largest institutions to fundamentally rethink their strategic priorities. This is particularly true of systemically important financial institutions (SIFIs), which are facing the brunt of new regulations—more stringent capital and leverage requirements being one of the more notable restrictions.

And even though the Volcker rule<sup>5</sup> has yet to be finalized, it is likely to prompt some banks to jettison their proprietary trading arms. On the mortgage front, origination and servicing rules are forcing banks to rethink their product offerings. Living wills, derivatives reform, and other aspects of the law are having similar effects.

While these regulatory drivers are not directly intended to promote specialization, they are, in many instances, indirectly accelerating this process.

Looking further ahead, as regulators adopt an increasingly "macroprudential" perspective to oversight—through SIFI designations, stress testing, "getting to strong," and other initiatives—banks' strategies may become even more subject to regulatory influence.

Another driver of specialization is banks' desire to reduce their organizational complexity. In part, this is a reaction to the downturn: complexity, not size, seemed to generate the greatest risks at many banks. By tightening their focus, banks hope to avoid some of the complex management problems they may have encountered just a few years ago.



# Benefits...and risks

Economic theory tells us that specialization offers many benefits. By focusing the firm on where it can better compete, executives may gain improved returns and more sustainable capital deployment. Other potential advantages include increased scale efficiency, more complementary business relationships, and improved brand alignment. A more focused company may also bring benefits from reduced complexity in terms of simpler management and strategic clarity.

Many observers and industry leaders see the benefits. That's why they are taking these steps, and why investors have rewarded some of the more aggressive specialization plans.<sup>6</sup>

Yet just because an institution is specializing, there is no guarantee it will result in a more efficient, nimble, and profitable organization. A number of factors might hinder the transformation into a more specialized institution. As banks change the scope and scale of their operations, previously marginal risks may come to the fore. The risks from complexity may decline, but new risks from concentration can become more prominent. Perhaps most importantly, strategic choices resulting in increased specialization (whether an intentional outcome or not) may have consequences for banks' ability to generate consistent performance by reducing the diversity of their income streams.

In addition, operational and execution risk, reputational risk, and investor risk may deserve special attention as specialization alters the business and operating models of banks.

The purpose of this paper is to highlight these considerations for bank management. In particular, we focus on the likely risks flowing from specialization and the actions banks might take to mitigate these risks.



# Defining and tracking specialization

Before assessing these consequences, it is important to articulate the three main dimensions of specialization: business, geographic, and customer.



**Business specialization** refers to the relative focus on a particular business or product. For instance, if a bank with operations primarily in mortgage lending and credit cards decided to sell its credit card business, its specialization along the business dimension (i.e., toward mortgage lending) would increase. It would be more focused, concentrated in, and dependent upon its mortgage business. (Similarly, if it decided to keep its credit card business at the same size but double mortgage origination, its specialization would also increase.)



**Geographic specialization** refers to the relative focus of an institution on particular geographies. As with business specialization, increased geographic specialization can result from either a decision to wind down operations in some countries or regions and not (or less) in others, or through a decision to ramp up operations in a subset of countries, regions, or markets while keeping the rest broadly constant. So, leaving the Asia-Pacific region, doubling down on Latin American business, or restricting branch openings to the Midwest would all be examples of geographic specialization.



**Customer specialization** refers to the relative focus of an institution on a particular type of customer. It differs from an across-the-board “customer-centric” organizational strategy in that it entails a decision to focus on a specific customer group rather than view the business from the customer’s perspective. Reworking an institution to focus on institutional investors or the underbanked would be examples of customer specialization.

Of course, these dimensions are not mutually exclusive, especially in as complex an industry as banking. A decision to specialize in certain customer segments may mean increasing focus on specific geographical areas. A decision to grow a retail business may involve increased focus on a particular customer group. But though overlaps are possible, the dimensions are distinct: it is possible to change one without materially affecting the others. In the current environment, specialization via shrinking or exiting certain businesses appears to be an especially common strategy pursued by banks. However, it is important to note that not all shrinking is specialization—a company that trims noncore, capital-intensive, or less profitable businesses evenly across the organization may not actually be specializing. It is important to point out that growth is still the primary motive behind specialization. Even if shrinking in some areas, institutions generally try to position themselves for growth—it’s just the first step that differs.

# Strategic choices in action

An exhaustive categorization of specific institutions' strategies would be endlessly debatable. But there are many prominent examples of specialization among large banks, and the aggregate evidence supports these individual cases.

The strategies of three early movers in specialization illustrate the variety of possible forms it can take.

## **UBS: Honing businesses and customers to improve performance<sup>7</sup>**

In its own words, UBS is "exiting certain business lines, predominantly those in fixed income, that have been rendered less attractive by changes in regulation and market developments."<sup>8</sup> At the same time, it is redoubling its focus on wealth management and seeking to grow that part of the bank's business.<sup>9</sup>

This business specialization towards wealth management naturally reflects specialization toward affluent customers as well. (UBS has regained its place as the world's largest private bank.)<sup>10</sup> But while the bank is increasing its specialization in certain businesses and customer groups, it does not appear to plan major changes to its geographic footprint.

UBS, as well as having one of the boldest specialization strategies, may also be one of the first to see it bear fruit. Strong first quarter 2013 results and improved stock performance, at least, support this interpretation.

## **Citi: Accelerating growth through the right mix of customers and geographies**

Citi is undertaking a vast strategic reworking of its businesses, marking at least a quarter of its assets for wind-down or divestiture,<sup>11</sup> and, in contrast to UBS, beginning a significant restructuring of its geographic footprint. These changes are, like others', intended to improve efficiency and spur growth. Also like others', changes likely reflect regulatory pressure to reduce complexity and strengthen balance sheets.

Along the business dimension, Citi has divested its Smith Barney retail brokerage joint venture, exited several consumer finance businesses, and spun off various smaller units. Geographically, Citi is also exiting markets such as Turkey, Paraguay, and Pakistan, where it sees limited alignment with its goals.<sup>12</sup> This geographical realignment, though major, is in large part a product of Citi's focus on affluent urban customers: The bank is increasing its focus on the top 150 urban areas worldwide.<sup>13</sup>

In its own words: "Citi's 2012 results showed ongoing momentum in most of its core businesses, as Citi continued to simplify its business model and focus resources on its core Citicorp franchise while continuing to wind down Citi Holdings as quickly as practicable in an economically rational manner."<sup>14</sup>

The interaction between Citi's customer strategy and geographic decisions illustrates the possible links between different types of specialization, in that the decision to increase focus on affluent customers resulted in increased specialization along two dimensions.

UBS and Citi typify what might be seen as the most common form of specialization among global banks. While they are making strong efforts to grow certain parts of the bank, cuts and exits are a major part of their initial specialization. They aren't alone: HSBC, Barclays, and others are following similar paths.<sup>15</sup>

## **Wells Fargo: Making a big push into mortgages, but also focusing on wealth management and other strategies**

In contrast, Wells Fargo has specialized by dramatically increasing the scale of its mortgage origination business, taking market share from competitors over the last few years. In 2007, it originated 11 percent of all U.S. mortgages; by 2012, it originated nearly three in ten.<sup>16</sup> That said, the bank has taken steps to mitigate its business concentration by building out wealth management and other less correlated businesses.<sup>17</sup>

These business decisions are also, at least in part, the product of longstanding specialization in retail banking customers.

### M&A data supports the specialization trend

The trend toward specialization is also evident in aggregate measures, especially along the business dimension. As noted in the introduction, the average proportion of divestitures to total M&A activity at financial institutions has nearly doubled to 48 percent in recent years.<sup>18</sup>

Moreover, this figure does not capture specialization such as Wells Fargo's or changes that do not result in the sale of a business unit or asset portfolio.

Yet it is important to note again that not all banks are specializing, and not all strategic shifts are evidence of specialization. News that a bank is adding slightly to its wealth management division can hardly be considered specialization if it is already highly specialized in the capital markets advisory business. And efforts by banks to reduce risk-weighted assets, while involving the sale of "noncore" units, may not result in an institution markedly more specialized than before.

Specialization is more than an abstract concept. It is a major strategic trend in the banking industry. And as with all strategic decisions, its risks should be assessed alongside its benefits.

### Identifying risks

Execution of the specialization strategy can be challenging and presents a number of risks that may not be new, but will likely be more prominent. Many of these risks are likely to fall outside the historically circumscribed role of the risk function; organization-wide attention to risk is required to monitor and manage potential issues. Specifically, an analysis of shifts in concentration risk, operational and investor risk, and reputational risk bears consideration as a bank makes decisions about its future.

### Concentration risk

The Basel II agreement labeled concentration risk as "any single exposure or group of exposures with the potential to produce losses large enough (relative to a bank's capital, total assets, or overall risk level) to threaten a bank's health or ability to maintain its core operations."<sup>19</sup> It goes on to add that "risk concentrations are arguably the single most

important cause of major problems in banks." Individual regulators' assessments—not to mention Basel III—confirm this opinion. Imprudent concentrations in areas such as residential and commercial real estate lie behind recent failures in the United States, and the Bundesbank has attributed "numerous banking crises" to increased concentrations—to name two examples.<sup>20</sup>

Banks are familiar with the assessment and management of concentration risk in their credit portfolios. The same principles may also be extended to the overall portfolio of the institution's activities. Intuitively, as institutions specialize in a particular business, customer, or geography, they can become more vulnerable to events in their focus area. While the total number of risk sources the institution monitors may decrease, they may become more vulnerable to the fewer risks that could impact them.

A likely consequence of over-concentration in businesses, geographies, or customer groups is revenue volatility. A more specialized institution may be able to build its reputation and expertise, boosting revenue potential, but will also become more dependent on its primary business line, thus more vulnerable to headwinds and pressures in that sector. Specialization may increase the consequences of a negative risk event. In this sense, the shift to the institution's risk profile is the reduction of the portfolio effect.

Of course, many banks are pursuing less-volatile businesses as part of their strategy—so quarter-to-quarter or year-to-year volatility may actually be reduced. The point is that specialization increases the vulnerability of a bank's performance to events and trends in its chosen specialty, creating a substantial if infrequent risk—even as banks reduce the number of major risks they must account for.

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**While the potential benefits of specialization are likely to be many and are widely anticipated, less attention has been paid to potential difficulties and downsides.**

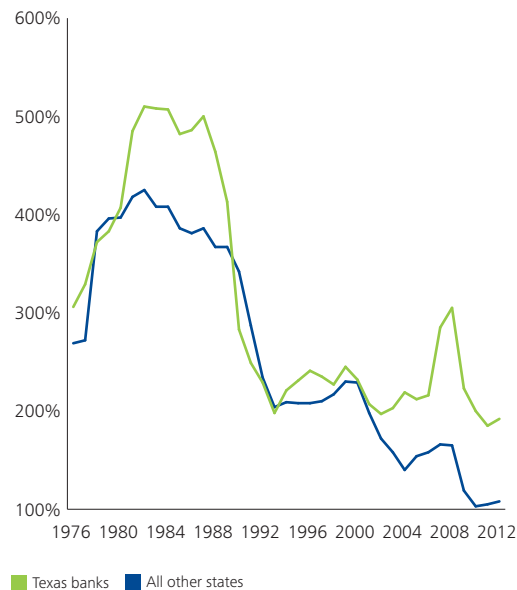


### Looking back to look ahead: Texas banks in the 1980s

One of the better illustrations of the combined risks of business, geographic, and customer concentration is the experience of Texas banks in the 1980s.

Spurred by oil price increases in the 1970s, the Texas economy, then more closely tied to oil than now, entered a boom period that lasted through the first half of the 1980s. The high price of oil spurred exploration and development activity, as well as new commercial real estate construction—heavily financed by Texas banks.<sup>21</sup>

Figure 2. C&D and C&I loans as a percent of equity



Source: FDIC Historical Statistics on Banking database

This period resulted in Texas banks simultaneously becoming specialized along all three dimensions: customers, products, and geographies. Many banks were heavily focused on lending to customers in the energy sector or related development projects. Banks' balance sheets developed large concentrations of construction and development (C&D), commercial and industrial (C&I), and commercial real estate (CRE) loans—all of which were in some way reliant on the energy sector. By the end of 1984, loans for C&D (including some oil exploration lending as well as CRE) accounted for 14 percent of Texas banks' loan portfolio—up from 8 percent in 1981.<sup>22</sup> C&I and construction loans reached more than 500 percent of equity by 1982, compared to the rest of the industry at 408 percent (Figure 2).<sup>23</sup> Fatally, this crisis predated the interstate banking era and no banks were able to benefit from geographic diversification—Texas regulations limited banks to a single branch per bank until the late 1980s.

Oil prices reached a cyclical peak in 1981 and then declined slowly before falling approximately 40 percent in 1985. Repayment rates collapsed along with oil prices. By the end of the decade, nine of the 10 largest Texas bank holding companies fell victim to the crisis, having either failed or been purchased under distressed conditions.<sup>24</sup>

Clearly, in this example, Texas banks suffered from concentration risk. Their experience is a cautionary tale: Despite many potential benefits to specialization, concentration risk should be carefully managed to protect the bank's safety and soundness.

### Operational and execution risk

Executing on new strategic priorities is usually fraught with challenges. For specializing institutions, the changes to the structure and goals of the firm may generate difficulties in a number of areas. At the most fundamental level, changes related to specialization may require a substantial reevaluation of banks' efforts to meet the standards codified by the Basel Committee on Banking Supervision.<sup>25</sup> Aspects from risk appetite statements to operational risk frameworks and reporting structures may need to be realigned to match regulatory expectations; banks making substantial strategic decisions will have to be careful to reflect new risks in their revised policies.

Scaling operations up or down can present consistent challenges in infrastructure and processes. Rapid changes toward specialization may produce costly gaps in technology and support structures. Reliance on third-party vendors, which regulators have recently scrutinized, may expand as banks fill resource gaps or as new structures require. Managing the changing infrastructure requirements is an important aspect of transitioning to a more specialized institution.

The changes required to become more specialized are also likely to have consequences for a bank's culture. In some cases, narrowing scope may actually aid management's efforts to create a strong, goal-oriented culture. However, where change is more dramatic or specialization alters a part of the company that previously was an integral part of the corporate identity, lack of clarity, communication, and leadership may create serious operational and executive risk.

Insufficient attention to the impact on culture can create problems in human capital management. Lack of understanding about how strategic goals will affect staffing could negatively affect retention or productivity, even in unaffected areas. If an institution is specializing by growing strongly in a specific area, demand for talent could outstrip supply, threatening the bank's strategic plans.

More broadly, existing management and governance structures may be ill-suited to the reshaped organization, jeopardizing a bank's ability to execute its strategy and comply with regulatory guidelines.

### Investor risk

Outside of the traditional risk management domain, banks considering their specialization strategies should keep in mind the perils of investor risk. Changes in focus can be misunderstood or negatively received by investors and strategically shrinking institutions could find that increasing profitability may be lost in news of reduced revenues. Even if management believes a rigorous growth plan is in place for the specialized future, observers might not agree. For specializers, growing immediately or not, uncertainty about the institution's plans can generate negative sentiment. Such perceptions may prompt some investors to question the strategy and abandon the stock, especially when short-term returns are below expectations.

Conversely, investors may also respond positively to action. UBS, one specializer, has seen its stock appreciate significantly since announcing its plans.<sup>26</sup> While not all of the growth in stock price may be attributed to the new specialized strategy alone, improved performance along several dimensions could suggest specialization was a wise move.

### Reputational risk

As banks specialize, they may experience damage to their reputation, especially if business diversification formed the core of their reputational capital or brand appeal. (For example, brand equity built on a global business presence may be diluted by a decision to retreat from some international markets.) This reputational loss may lead to dilution of client relationships. Exiting areas closely related to the bank's reputation may cause current and potential clients to doubt the broader health or capabilities of the institution. This doubt could cause the bank to miss out on new customers and opportunities even where it would be highly qualified. At the extreme, the specializing bank may experience unwanted attrition.

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**Managing the changing infrastructure requirements is an important aspect of transitioning to a more specialized institution.**



### **Systemic risk consequences of specialization**

Specialization also has systemic risk consequences. These risks are likely to be front-of-mind for regulators, who have strong direct and indirect influence on banks' strategies. Often, regulatory and legislative mandates have created the impetus for specialization—though that might not be the intent of post-downturn policy.

For regulators, the most important consequence of specialization may be in systemic concentration. As banks (and other financial actors) indirectly or directly specialize, financial markets will experience a reduction in the number of firms serving given roles, geographies, or customer groups. This concentration can have important implications for systemic resilience because as the number of firms in a given space shrinks, the remaining firms' systemic importance is likely to increase. In certain markets or businesses, a system of highly specialized large banks could generate substantial risk.

This higher market concentration could increase the number of counterparties exposed to a particular institution and reduce available substitutes in the event of unanticipated shocks. So the failure of a given institution is likely to have a larger immediate impact and be harder to resolve.

At the same time, highly specialized institutions themselves are likely more vulnerable to shocks in their chosen specialties, increasing the risk of trouble at the bank level.

Though regulatory actions that accelerate bank specialization may reduce the systemic risks posed by institutional complexity and breadth, they could actually expose systemic risk in other areas and potentially increase the fragility of the financial system. While these risks may not yet be evident, regulators and banks should pay close attention to signs of their emergence.

# Managing risks

Changes in concentration risk, operational and execution risk, investor risk, and reputational risk can substantially alter a bank's risk profile. While these risks may not negate the benefits of specialization, each needs careful planning to address. Managing these four risks will likely require both implementation of known leading practices and new ways of looking at bank strategy. Doing so is likely to drive a bank's ability to achieve the benefits of specialization.

Concentration risk, to a certain extent, should be managed at the level of a bank's overall strategy. Many banks already factor concentration into their strategic decisions, at least informally, but they may lack the framework or operational discipline required to fully manage the consequences.

Thinking of strategy's concentration effects along business, geography, and customer dimensions is likely to offer useful insights for risk management. In planning their strategies, banks should be wary of decisions to specialize across all three dimensions. The logic dictating this caution is simple: concentration may be increased to the point where the benefits are outweighed by potential volatility or increased vulnerabilities. At the extreme, such a strategy could present substantial risks to a bank's resilience. Recent history of

## **Integrating risk management: a need for transformation?**

As newly specialized banks adjust to their changing risk profiles, they may wish to take the opportunity to consider the implications of these changes for their broader risk culture.

Over time, a changing institution's risk management practices can gradually become misaligned with the operating model. This lack of alignment may leave banks vulnerable to unanticipated risks and slow coordinated responses when they are needed most. Misalignment is a potentially costly barrier to robust risk management.

Deloitte's forthcoming report on "risk transformation" offers a framework and guidelines for the difficult process of cultivating a strong risk culture in the context of a changing industry.

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## Managing these four risks will likely require both implementation of known leading practices and new ways of looking at bank strategy.

highly specialized large institutions may caution against pursuing such a course without careful thought.

On a more operational level, the increasing importance of firm-level concentration risk will make appropriate risk metrics and stress testing even more essential risk management tools than before. Developing and refining appropriate metrics for these macro-level concentrations can be an important first step; routine and comprehensive stress testing will allow institutions to better monitor their institutional exposure within the credit portfolio and beyond. Institutions that treat stress testing as the valuable tool it is—rather than a compliance exercise—may be rewarded with insights that can help inform strategic decisions concerning specialization.

For operational risks, talent and culture messaging is likely to play a crucial role. Clear and transparent communication of strategic goals may help current staff better understand why, when, and how the organization will change. And for institutions growing rapidly, cultivating strong institutional understanding of strategic goals may better motivate current and prospective employees.

The same principles banks deploy to manage talent-related risks may also apply to investor and client relations. Transparency—and a persuasive case for change—is likely to be essential to maintaining confidence. Heading off operational issues related to mismatched governance, processes, and infrastructure may initially limit cost savings but prove prudent and efficient over the long run. Strategic clarity will go some way to helping identify mismatches where they occur, but it cannot fix them. Firms should be willing to invest time and money to lay the foundation for the execution of their strategy; the scale sufficient to generate sustainable margins will not always come quickly.

# Visualizing a new industry landscape

Many large banks are specializing along one or more of the three dimensions of specialization: business, geographic, and customer. Some early movers have already implemented many of their plans. Others are just beginning, and more may be ready to follow suit. Specialization potentially carries many benefits to institutions that carefully assess their core strengths. But it is not without its own perils. As banks specialize, each is likely to see substantially altered risk profiles, and all will face challenges in turning a refined business model into a powerful operating model.

The trend toward specialization raises important questions about the future competitive landscape of the industry. As many banks specialize, competition in some areas—perhaps wealth management or certain emerging markets—may significantly increase as many banks attempt to cut slices from a growing pie. Other less obviously attractive businesses, regions, or customer segments may become the province of just a few large but highly specialized banks, much as has occurred with custodial services.

This pattern has consequences for individual banks, their customers, and the system. Increased competition in some areas could bring benefits to clients and customers, while diminishing the systemic risk posed by the collapse of any one institution in that area. In contrast, a reduced number of firms competing in certain areas could increase the fragility of the financial system—an unintended consequence.

Exact outcomes are impossible to predict. What does seem clear is that the industry is in the midst of a structural realignment toward specialization, driven by new regulation and performance pressures. This shift, while it has its roots in the events of the past few years, could likely position banks to finally move beyond the post-downturn era—provided banks and regulators can effectively manage the risks they incur along the way.



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## Endnotes

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