



## Don't Bank On It. . .

Time for a makeover if the banking industry wants to be relevant in the 21st century!



Imagine this scenario—You've just taken over your father's restaurant, a popular neighborhood fixture for fifty years. You step into the dining room and are shocked to find that only half of the tables are full and that the customers are all in their 80's. But you've promised Dad that you're going to grow the business. Do you:

- Call Gordon Ramsay and request a complete reality show makeover; or
- Sell all the diners a half-priced dessert and call yourself a genius?

Unfortunately for the American economy, our middle-market commercial lending institutions have chosen b) for far too long. They operate a business model that worked brilliantly to finance the post-WW II manufacturing boom but that is sadly out of step with today's value drivers. The result—a Catch 22 situation in which banks can't find enough solid "traditional" lending opportunities while our most promising young companies can't find financing. How can this be?

### What do banks do?

A commercial bank balance sheet is highly leveraged. This means it carries a lot of debt, in the form of deposits and other types of borrowings, so it doesn't have much capacity to absorb losses. Thus, it can't (shouldn't, anyway) make investments that are very risky. Historically, and even today, banks focus on lending against assets, mainly on the theory that if the borrower doesn't make it, the bank can sell those assets and get its money back.

Banks like assets that one can see and touch (plant and equipment, inventory) or that are obligations of other companies (accounts receivable). In a traditional manufacturing economy, there are lots of these assets to be financed, and, as that economy grows, there are even more. Companies borrow, banks lend, everybody grows, and everyone is happy.

Over the last thirty years, though, and especially over the last fifteen, there's been a sea change. Much of this country's growth has come from the service sector, which doesn't require big factories or machines. Companies have gotten smarter about collecting receivables and managing inventory, so these investments have gotten smaller, too. And technology developments, most notably the Internet, have enabled lots of businesses to grow without many traditional assets at all.

If you're in the business of financing assets, this is a problem.

### What do companies need?

American enterprise still needs capital, but the investments it makes these days look very different. Value today is created not by building bigger factories to crank out widgets. Instead, it resides in assets that are much less tangible, but no less real. Innovation, creativity, skill sets of employees, brand equity—these elements make a business worth far more than the number on its balance sheet.

So capital is being deployed—and very efficiently, in many cases—in areas such as product development, technology, marketing and sales, and sophisticated delivery capabilities. And, overall, these investments are paying off in spades.

But, alas, banks don't like to finance these. Nothing to see, touch, or sell. Far too risky for the average, old-model, banker.

Therein lies the disconnect. And the banker is left looking at a half-empty dining room and 80-year-old customers.

### So, how do we fix the problem?

To date (and sadly), too many bankers have clung to choice b). They've sold those diners half-price desserts by lending against another asset that everyone can see and touch, one that can always be sold if the borrower can't pay—at least until it can't. That asset is called real estate. And we all know how that's played out.

So, with apologies to Chef Ramsay, here's our prescription for a makeover—no reality show required.

- Better understanding of risk—how to analyze it, price it, and manage it. Banks are investors and need to start acting like it. In order to do this, though, they need a few other elements, such as:
- Focus on return on investment—not on asset growth. Getting big is easy—if you don't worry about the risk/return tradeoff—but it's not the point.
- Smart people—who are selected, trained, managed and compensated as investors. Turning lenders into "salespeople" was probably the single worst mistake the industry made.
- Lower leverage. If banks are going to take on more risk in the investments they make, they must carry less risk in their capital structure.
- Appropriate (this means higher) pricing. Take on more risk, but charge for it. Borrowers should be OK with this if they can deploy the capital effectively. After all, it's their job to generate returns for all of their investors, including the banks.

Change is never easy but, in business at least, it's essential. Unless America's commercial lenders are willing to come up to speed with the rest of the economy, they will continue to fight each other for fewer and fewer opportunities while someone else makes the returns. And that, in our view, would be tragic.

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### CLIENT NEWS

## Pivot Design Rolls Out Major Branding Program

Pivot Design, an award-winning graphic design agency specializing in complex B2B brands, recently launched a bold new brand program for Microsoft Technology Centers worldwide. An extension of a longstanding relationship with Microsoft, the rollout included an updated website, print collateral, interior graphics and signage, e-communications materials, and complete brand guidelines. It has been enthusiastically received by the marketplace.

Pivot Design was founded by Brock Haldeman in 1992 and has been the creative force behind Perimeter Advisors' look and identity since 2004. Other notable Pivot Design clients include Accenture, Baxter, Chicago Stock Exchange, Children's Memorial Hospital, Equity Office, and McDonald's. Congratulations to Brock and the Pivot Design team!

Learn more at [www.pivotdesign.com](http://www.pivotdesign.com).

## Karin O'Connor to Participate in Hong Kong Conference

Perimeter Advisors founder Karin O'Connor will be participating in the Kellogg 2010 Asia IMPACT Series Conference in Hong Kong on March 19 and 20.

The Conference will examine the impact of the recent global financial crisis on Asia and the profound effects the recession has had on multinational businesses and international business practices.

The Conference is sponsored by the Kellogg School of Management at Northwestern University and will feature a keynote address by Professor K. C. Chan, Hong Kong SAR's Secretary for Financial Services and the Treasury and former Dean of Business and Management at the Hong Kong University of Science and Technology. Kellogg's Interim Dean Sunil Chopra is a featured speaker, and distinguished Kellogg faculty will present timely topics in marketing, finance, and risk management.

Karin is a Kellogg graduate and currently serves on the Kellogg Alumni Council.