

Banks Are Still Thinking Short-Term



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A single-minded focus on the bottom line can destroy value.

Among the multiple organisational failures that led to the global financial crisis, one is fairly well buried in the debate. Much was made of the incentives that skewed short-term risk taking but behind these misguided incentives was a single-minded focus on the bottom line.

Broadly speaking, large banks failed to properly define and assess value, making it difficult for managers to achieve long-term success. For example, the singular profit-as-incentive strategy to motivate employees to meet goals meant value was, in fact, destroyed. According to “Blue Line Management: What Managing for Value Really Means”, a concept and book (*[The Blue Line Imperative](#)*) developed by INSEAD Professors David Young and Kevin Kaiser, business decisions can only ever create value or destroy it.

Value destruction, especially when allowed to happen over extended periods, can wreak havoc, as the global financial crisis showed. This has implications far beyond staff, investors and clients and still challenges the financial industry today.

Banks are still going wrong

Many financial institutions are currently plagued with significant budget and cost problems. This is largely the result of increasing costs due to growing regulatory compliance and mushrooming IT expenses.

The IT budget makes up a substantial part of direct and indirect costs and hence is the target of any meaningful cost-reduction exercise. A large bulk of an IT budget is allocated towards run-the-bank (RTB) IT expenses. This is a cost that needs to be spent to simply keep the existing technology platform running. Typical items here are IT staff, market data, hardware amortisation, software and vendor costs, and sometimes external consultants. A substantially smaller part of the budget is the change-the-bank (CTB) budget. These are expenses the bank incurs to change its existing platforms and are mainly driven by regulatory change, product change, system enhancements and client experience enhancements.

As banks have become increasingly cost conscious, overall IT budgets have come under increased scrutiny. Reducing RTB costs can be very difficult. Short of reducing business complexity or investing in CTB to implement system enhancements, the bank, in the short and medium term, must fund these costs completely. This leaves cuts in CTB budgets as the only realistic option. But even these cuts can be exceedingly difficult to implement in practice. Departments within the bank often engage in fierce disputes to improve their technology platforms. The front office is usually most interested in enhancements to client interface and user experience. However, regulatory and product changes tend to take priority within the organisation to ensure that legal, compliance, tax and reputational issues are kept to a minimum. The required CTB budget allocation in these areas simply takes priority over modifications the sales or front office teams would like to see.

Under these conditions, how can the IT project managers obtain approval for their annual budgets to please internal clients – for example, the front office – to still find some CTB budget to enhance client experience when RTB and CTB expenditures focused on regulatory change are eating up the IT budget?

One way he or she could do this is to become creative and shift costs from the profit and loss statement (P&L) to the balance sheet.

Typically, the Finance department would allow certain projects to be classified as long-term enhancements to the IT platform and hence the bulk of associated costs for these enhancements are classified as assets instead of booked as expenses on the income statement. The assets are eventually expensed through the amortisation process, but only gradually, typically over three years. To track this, an internal cost centre is created, against which all costs associated are booked and later capitalised.

Pizza on the balance sheet

What does this look like in practice? Late one night, as the IT project team exceeds their normal working hours, they are entitled to dinner at the company's expense. They call for pizza delivery as they continue working and, of course, the pizza cost becomes part of the IT project costs, booked against the project IT cost centre. When the project is completed, the original pizza costs form part of the overall IT enhancement asset capitalised on the balance sheet, ready to be written off over the next three years. In one case we know of, the balance sheet included US\$3 million of such costs. Although the notion of calling US\$3 million in takeaways an asset seems absurd, it does allow the bank to stay within its CTB budget and also offers the additional benefits of boosting reported profits in the short term. The question of value or value creation is seldom asked in this scenario.

The costs of pizza as part of a project are, of course, minor but this example illustrates the extent and absurdity that this results in. And if this is done with pizza, what else do banks have on their balance sheet that from a common-sense point of view should have been written off?

This behaviour may seem relatively harmless for a bank with a big balance sheet but it demonstrates a certain mind-set that is clearly contrary to value creation. To further illustrate the seriousness of a lack of value-driven decision making in the financial sector, we will turn towards a more serious topic – corporate mergers and disposals – in our article next month.

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