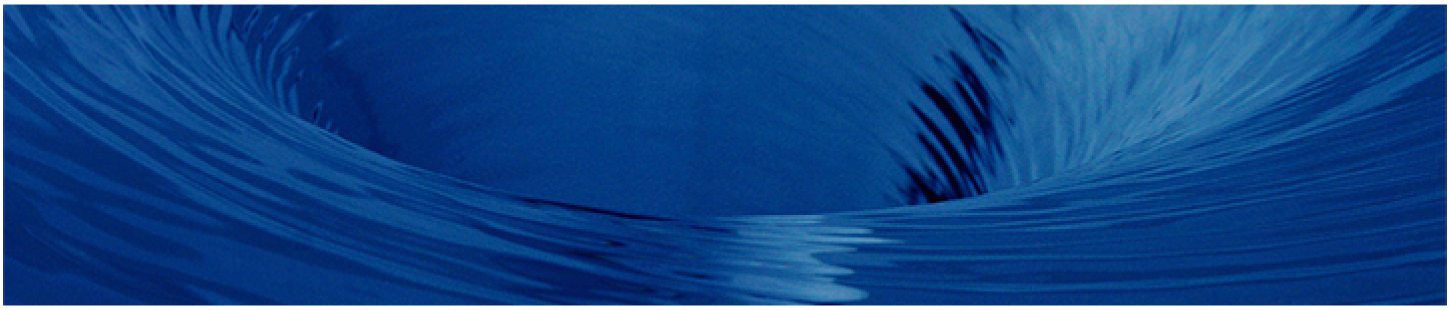
TOMORROW'S CHALLENGES



HOW SAFE IS VALUE EXTRACTION?

ALTHOUGH VALUE EXTRACTION IS WIDESPREAD, BACKLASH IS GROWING. IS THERE ANYWHERE LEFT TO HIDE?

By IMD Professor Paul Strebel and Salvatore Cantale

IMD
Chemin de Bellerive 23
PO Box 915,
CH-1001 Lausanne
Switzerland

Tel: +41 21 618 01 11
Fax: +41 21 618 07 07
info@imd.org
www.imd.org

Ten years ago banking secrecy was the bed-rock of Swiss banking's wealth management business. Today banking secrecy is gone. Switzerland has agreed to the OECD's automatic exchange of client banking information. For decades Swiss private banks used the country's legal protection of individual financial privacy to offer tax evasion advisory services, at the expense of the countries where their clients' wealth was created. With hindsight, it is clear that they should have been much more careful. What is it about these activities that should have alerted them to the risks?

Looking back at the way the world was, it is difficult to argue that they should not have taken advantage of Swiss banking secrecy. Or, that they should not have participated in the growth of the U.S. mortgage derivatives market prior to the financial crisis. The problem with these activities was that they were based, not on value creation, but on value extraction. Value extraction involves capturing value from other stakeholders by distorting the competitive market process. Tax evasion advice distorted the fiscal receipts supporting the markets for government services. Opaque mortgage derivative products distorted the markets for fixed income products.

Although value extraction is widespread, the societal backlash is growing, accompanied by tighter regulation and a technology-driven trend towards more transparency and accountability. As one CEO put it, "there is no place left to hide".

Identifying Dependency on Value Extraction

Value extraction can become addictive, to the point where it drives out real value creation based on innovation and efficiency. The classic case is that of Enron which found it easier to book paper profits than develop competitive value propositions. It finally got sucked into fraud to capture value. To avoid the potentially fatal attraction of value extraction, the board and top management first have to identify the dependency on value extraction by looking at the ways in which it is done.

Manipulating markets to enhance profits

This involves using political influence, market power, or deception to restrict competition and distort market pricing. Carlos Slim benefitted from political influence to develop his mobile phone business which controls most of the land and mobile lines in Mexico. The country has very high mobile phone costs, low internet penetration and ranks among the bottom countries in telecom investments per capita. Microsoft has been repeatedly accused of using the market power of its software platform to extract value by restricting competition and overcharging customers, for which it has incurred multiple legal penalties. The banking industry created and took advantage of the deceptive pricing of mortgage derivative products while accumulating profits prior to the financial crisis.

Exploiting market distortions to socialize costs

This entails using already existing market distortions to shift costs onto society, like the unpriced effects of pollution, poor working conditions, or arbitrary government favors, such as subsidies, tax-breaks and implicit guarantees. Prior to recently raising its minimum wage rate, Walmart has been repeatedly accused and penalized for exploiting its workers with low wages and benefits in local labor markets that it dominates, thereby shifting basic living and health-care costs onto society. The Swiss private banks took advantage of the particularities of Swiss tax legislation to facilitate tax evasion, thereby depriving their clients' countries of public revenues.

Evaluating the Sustainability of Value Extraction

Two forces can make value extraction unsustainable:

Legal and reputational costs become unbearable: The legal and regulatory environment, influenced by affected stakeholders, social opinion and the media, impose unbearable costs on value extraction. Swiss banks misjudged the speed with which cash-strapped governments, especially the U.S., would become intolerant of tax evasion. The oldest Swiss private bank, Wegelin, which refused to hand over client and employee names, was indicted and could no longer operate in the financial markets. It sold off the competitive part of its business, paid the fine and liquidated.

Easy money from value extraction erodes the competitive advantage of the business model: Many of the investment banks that participated in the mortgage derivative boom did so well that they did less and less to increase the competitiveness of the rest of their business model. When the mortgage pricing bubble burst, some of the business models were so weak they had to be restructured, or closed. Some of the major banks, after resisting for several years have realized recently that their investment banking models are not viable and have initiated the painful process of restructuring.

In brief, value extraction is increasingly under threat in today's rapidly changing regulatory and societal environment. To avoid unpleasant surprises, the board and management have to identify how much the business model depends on value extraction and, more crucially, to what extent the related easy money is eroding competitiveness. For long-term sustainability, the organization has to be weaned off value extraction and the emphasis placed on greater innovation and efficiency.

Paul Strebel is the Sandoz Family Foundation Professor of Governance, Strategy and Change at IMD. He teaches on the following programs: High Performance Boards, Executive MBA (EMBA), and Strategies for Leadership.

Salvatore Cantale is Professor of Finance at IMD, where he teaches on the following programs: Orchestrating Winning Performance (OWP), Building on Talent (BOT), Executive MBA (EMBA), and Strategic Finance (SF).

Related Programs

THE IMD EXECUTIVE MBA – http://www.imd.org/emba

Never stop learning
Program Director Stefan Michel

- A rigorous, diverse and global program for experienced executives
- Sharpen your leadership skills, drive your learning into your company and fulfill your potential
- An execution-oriented program that focuses on turning ideas into action
- Thought leadership that you can put to use right away: earn a world-class MBA on the job

ORCHESTRATING WINNING PERFORMANCE – http://www.imd.org/owp

The global business program for individuals and teams
Program Directors Michael Wade and Dominique Turpin

- Get exposed to the latest management thinking and to practical and innovative solutions for your business
- Anticipate global business trends
- Boost your performance, broaden your perspectives and expand your global network
- Design the program that suits you and your team
- Become a complete executive through activities that develop your mental, physical, and emotional health