Editorial

A Smart Way to More Transparency

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The financial crisis currently disrupting the economic system and banking worldwide often gets blamed on securitization. Banks commonly use securitization to manage their portfolio risk and funding position by transferring loans and the credit risk of their loan portfolios to other investors. In return, the banks do not hold the loans until their maturity in their own books but instead receive earnings from them directly at their net present value. That is, instead of following a "traditional" banking business model, called "buy and hold", banks switch over to an "originate and distribute" model.

The move toward short-term profit realization, at the expense of long-term value creation, yields additional, largely ignored threats. The transformation of periodic loan payments into one down payment enables a bank to realize earnings immediately instead of doing so over the lifetime of the loans. Basically, this corresponds to the behavior of soccer clubs such as Schalke 04 which started to sell revenues of future ticket sales to banks and whose coach just recently realized the corresponding lack of income in the upcoming periods. Ambiguous requirements for financial statements provide limited means to detect such value shifts and make the consequences of securitization for long-term value creation not transparent, because banks (as well as other firms) are not required to report future earnings. Instead, they generate incentives to use securitization excessively to boost short-term profits. Such a lack of transparency can lead to severe problems. For instance, supported by accounting rules, managers have incentives to adjust the bank's earnings streams through securitization to better reach personal goals. Unfortunately, the problems that arise from such shifts in profit realization continue to be largely ignored in current discussions of the financial crisis.

In fact, our empirical results illustrate that many banks fail to provide sufficient transparency about their securitization activities. This lack of transparency makes it difficult for stakeholders, if not impossible, to evaluate which earnings come from ongoing banking business and which result from the one-time effects of securitization. Hence, an evaluation of the consequences for long-term value creation has to be omitted.

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Reports about customer equity, however, can depict a smart way of creating that demanded transparency in financial statements. Research has accumulated enough knowledge over the past decade to calculate customer equity, i.e. the value of a customer base, so that the predominant ignorance of future earnings is no longer justified. Based on that approach, we propose two means to reach more transparency.

- **Customer Equity Reporting (CER)** provides stakeholders with valuable information about the long-term value of a bank's current customer base and its development over time. It publishes detailed customer structures with related earnings and costs in absolute numbers to issue a forward-looking statement.
- **The newly developed Customer Equity Sustainability Ratio (CESR)** compares the likely future profit of the existing customers to the current profits. It identifies shifts in value realizations over time and reports the sustainability of the bank's earnings as a relative number in a simple and substantial way.

Both means provide the bank with an opportunity to offer stakeholders sufficient information regarding the time horizon of the bank's business model without disclosing possibly confidential information. The results of our recent counterfactual analysis of Countrywide (US) show that this bank shifted from a situation in which approximately 75% of the value created is realized in the future towards a situation in which 80% of the value creation is immediately realized.