

What's ahead?

Managing Banks Beyond the Crisis: The New Financial Landscape

What appeared to be the largely American subprime mortgage problem of 2007 has become the global financial crisis of 2008, when wholesale capital markets ceased to function, and governments were forced to intervene to recapitalize banks in the G7 economies. Starting with Britain and followed by the European Union and then the United States, the public sector is now committed to:

- *Guaranteeing medium-term loans between banks for up to five years*
- *Ensuring appropriate liquidity conditions for financial institutions*
- *Facilitating the funding of banks*
- *Providing financial institutions with additional capital resources*
- *Allowing for efficient recapitalization and, if necessary, restructuring of distressed banks*
- *Applying sufficient flexibility in the implementation of accounting rules*

Lessons

European leaders pledged that, “Governments remain committed to avoiding any failure of systematically relevant institutions, through appropriate means including recapitalization. In doing so, we will be watchful regarding the interest of taxpayers and ensure that existing shareholders and management bear the due consequences of the intervention.” This promise was presented the same weekend that G7 finance ministers declared there would be a concerted effort to fend off what the International Monetary Fund director Dominique Strauss-Khan said would be “a systemic meltdown.”

Around the world, other countries fell into line with the G7 and European commitments, with Australia and the Emirates issuing bank deposit guarantees, Taiwan limiting its stock market and Saudi Arabia announcing its own bank bailout fund. Moreover, the International Working Group of Sovereign Wealth Funds, representing the 26 most important countries with such funds,

agreed to a set of international standards on transparency, accountability and good governance with a commitment to financially (rather than politically) motivate investments, and “to helping maintain a stable global financial system.”

The immediate crisis has been eased, if not halted. Three immediate questions remain:

- 1) How and when will governments end their investments in the banks?
- 2) What influence will they exert on banking procedures while they are such powerful investors? In particular, will they, for political reasons, require the banks to lend money against the banks’ own judgments?
- 3) What lasting regulatory changes should banks expect, and will these be severe enough to change the nature of modern banking?

It is important to recognize that there is life after the crisis. Banks will find ways to operate successfully, probably at



*As the old Chinese proverb says,
“When the winds of change blow,
some people build walls and others
build windmills.”*

higher levels of equity and lower levels of return. Capital markets will eventually revive and rejuvenate themselves, almost certainly with major changes in regulation. Customers, partners and regulators will view the financial world with some suspicion in the future, so the banking industry will experience a tighter focus on risk management, efficiency and customer care. A great deal of trust has been lost—the banks that succeed in the post-crisis world will be those that move most quickly and credibly to re-establish that trust.

The crisis is still underway, and its scope and implications are yet to become clear. But some preliminary lessons can be drawn:

- **First**, regulators and legislators are likely to demand complete transparency on bank balance sheets in the future—it will become almost impossible to list loans as being off the balance sheet and the originate-to-distribute model is unlikely to survive.
- **Second**, capital ratios will likely increase and achieving above-average returns on capital will become in-

creasingly difficult. The rules on down payments and collateral will become stricter.

- **Third**, high-risk and high-return business, like subprime loans, will be discouraged or increasingly require explicit ring-fencing.
- **Fourth**, anything that looks like “creative” or “innovative” banking is going to be frowned upon. All this suggests that banking is likely to become less profitable and risky and more of a utility. Security and stability will be the new watchwords.

Exorbitant Profits

Over the past decade, banks significantly increased their share of the profit pools. In the United States, for instance, banks account for a third of corporate profits but only 8 percent of GDP, and banking profits globally have increased at a significantly higher rate than the “real” economy (see figure 1). Although there are fundamental drivers in place – an ongoing increase in pension assets and higher leverage of companies – these levels will likely not be sustainable in the future. Reduced credit volumes, lower capital markets activity and continued margin squeeze will reduce the revenue pools banks can draw upon over a longer period of time. Furthermore, lower leverage from increased capital adequacy ratios will further reduce current return levels for banks. It is likely that realistic return on equity for banks will range from 10 to 15 percent rather than in the 20 percent range.

Banks are facing a number of immediate issues in their current budgeting and planning processes:

- How to ensure funding and increase deposit gathering
- How to respond to the credit squeeze and ensure that good risks continue to obtain credit

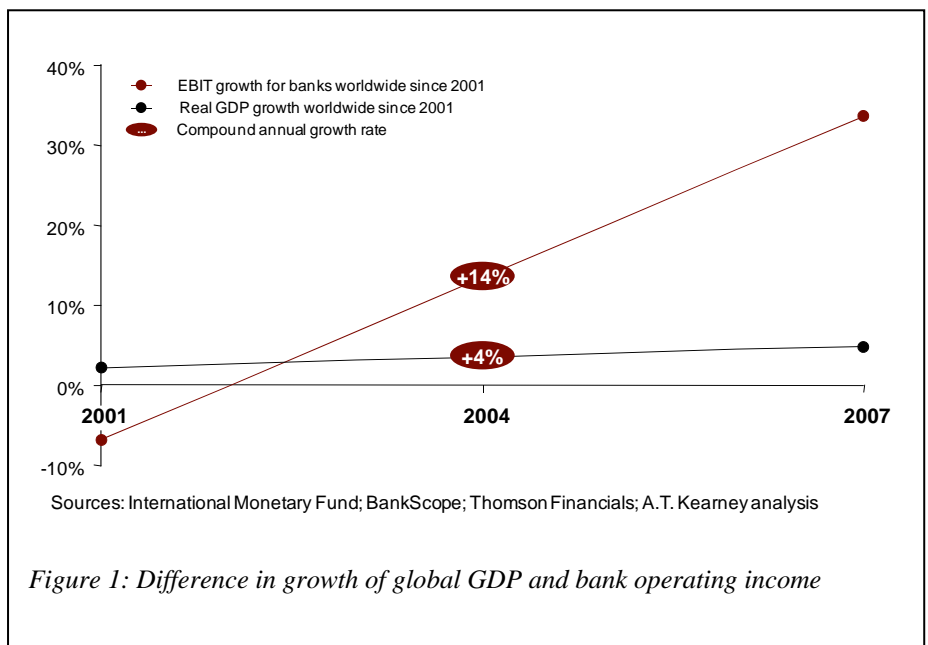


Figure 1: Difference in growth of global GDP and bank operating income

- How to deal with big international competitors that are buying into local banks
- How to down-scale infrastructures built for larger volumes, not only in capital markets, but also in retail lending

Answering these questions will be critical to surviving the crisis. And once the crisis is over, it will be important not to lose sight of what will likely become the emerging landscape and the drivers that

will shape the future of the global economy. In all previous financial crises, the worst seldom happened—the Domsday scenarios did not come true. Demographics, education levels, the rise in skills and consumer expectations, the spread of information technology and the new challenges in energy efficiency suggest that healthy rates of global GDP growth are likely to resume.

Restructured Capital Markets

The post-crisis banking system will not result in the end of capital markets for two simple reasons:

- 1) Capital markets have proven to be the most efficient way to allocate capital.
- 2) There is too much liquidity not only from sovereign wealth funds, but also pension assets seeking global returns. The mechanism will stay, its rules will be improved and capital markets will rejuvenate themselves with regulatory improvements. Those improvements will most probably focus on the following areas:
 - Addressing the information gaps and asymmetry, in particular around second-level derivatives
 - Improving transparency and ensuring better reliability of rating agencies (via examination processes, for example)
 - Upgrading risk management and capital requirements (“Basel 3”)
 - Widening the remit of supervisory authorities to include hedge funds
 - Controlling (if not prohibiting) off-balance sheet positions (which may be the trickiest part, as regulatory competition has actively been used, for example, to attract public and mortgage lenders to certain countries)
 - Implementing codes of conduct for sovereign wealth funds

The housing bubble will be addressed because politicians cannot afford to abandon the 20 to 30 percent of the U.S., U. K. and Spanish populations that have been allowed to bet on ever-increasing housing markets. For example, the U.S. Congress voted in a \$300 billion scheme for the Federal Housing Administration to subsidize and insure mortgages that

would otherwise foreclose—in effect, refinancing variable-rate mortgages into 30-year fixed mortgages. (In theory, this should cover 1.5 million mortgages of \$200,000 each. But with the rate of U.S. foreclosure applications in mid-2008 running at 300,000 per month, this program would cover only five months of defaults, and will thus almost certainly need enlarging.)

tion, tighter credit, disintermediation and efficiency.

Consolidation

To date the banking industry has been resistant to wider trends of global concentration and there is little evidence to show that increasing consolidation leads to increasing profitability (see figure 2).

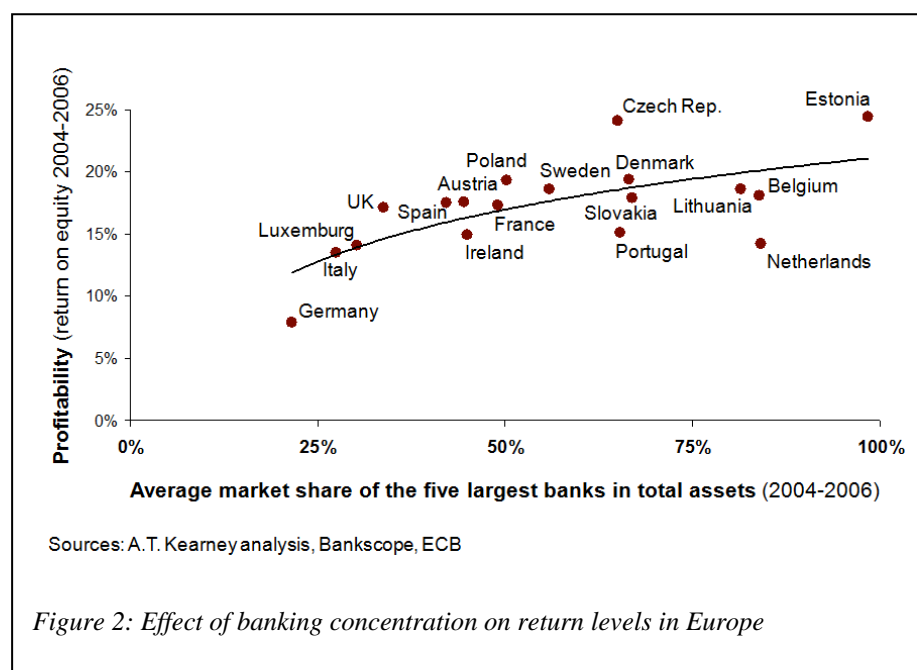


Figure 2: Effect of banking concentration on return levels in Europe

The same is true for the mispricing of derivatives, which will be addressed by supervision, regulatory measures and capital adequacy requirements. The high leverage ratios of investment banks (and a number of other banks that abused special purpose vehicles, conduits and off-balance sheet positions), hedge funds and private equity will be replaced by somewhat lower leverage. All this will result in a significantly higher transparency and robustness of the post-crisis banking system.

There are four other structural drivers that we view as fundamental for the post-crisis financial system: consolida-

Nevertheless, this crisis is likely to introduce a wave of industry consolidation for years to come. Several mergers have already happened, particularly in the United States. The three biggest banks globally, in terms of operating income, have increased their global market share from 7.3 to 8 percent within a year with the acquisition of Bear Stearns and Washington Mutual by J.P. Morgan. Although this is an almost 10 percent increase, the market concentration of the largest global banks (Citibank, J.P. Morgan and HSBC) is still much lower compared to a cross-industry average of 45 percent.

Tighter credit

The housing bubble will have severe and long-term effects on the banking sector and on the wider economy. Banks will have to tighten risk-management standards and revamp compensation schemes that have been accused of encouraging excessive risk-taking. More restrictive credit policies and regulatory requirements for subprime and predatory lending will limit the ability to finance investments. In this environment, the effect of the credit crunch on the mono-line credit card and consumer finance companies will be critical in Western economies and on stand-alone mortgage lenders.

Right now, it looks as if the impact of tighter credit will vary between severe and disastrous. Credit availability will decrease, shrinking some revenues for banks, while lending costs will rise, perhaps giving banks a healthier margin on credits than before. But any increase in margins will be eroded by the higher cost of monitoring and enforcing the new regulatory environment. With charge-offs increasing and customer confidence and consumption shrinking, banks will struggle to replenish their revenues through other sources. In addition, banks will need to adapt their operations to higher risk costs and lower margins and volumes—especially on the credit factory side.

Disintermediation

The impact of this can be quite disastrous for banks. While banks consolidate, corporations will increase efforts to become less dependent on bank credit for funding. There are three reasons that have made this reduction in dependency vital—frustration with banks, the selling of loans to other lenders and restricted credit policies (likely to be especially abrupt in the downturn). Testimony of this can be found in the Association of Corporate Treasurers' (ACT) advice to its members on how to protect their funding availability against “non-cooperative banks.” The overall theme of the ACT's advice is that corporations should protect themselves with clauses (“yank the bank” and “snooze and lose”) because market fortunes have reversed. While bank credit lines will clearly continue to be important, they could increasingly be used more on a standby basis, making equity increasingly significant and costly. Although this is not a new trend, and banks have benefited from developments such as mezzanine funding, the current crisis is likely to spur new forms of financial engineering and cash management among corporations that will decrease their dependency on banks, effectively leading to disintermediation.

Efficiency

Today's state of panic obfuscates the obvious – capital markets will eventual-

ly stabilize. The new mega-banks will face competition at least as intense as banks have faced in recent years. And with higher costs of capital and lower top-line and margins, they will very quickly be forced into significant programs to optimize asset-liability management, upgrade their risk management, and maintain and increase customer relationships. Once trust is re-established, it is that last factor of efficiency that will mark the biggest difference between leaders and laggards in the post-crisis financial world.

We can already observe significant cost differentials between leaders and laggards in banking. According to A.T. Kearney's benchmarks for almost 50 European banks, leaders are at 20 to 50 percent of the unit cost of laggards for a wide array of services from lending to payments. These differences will increase in importance in the post-crisis environment, triggering a wave of initiatives ranging from product rationalization to lean management to outsourcing and cosourcing to offshoring. Business models that were intrinsically deficient (like those of some German Landesbanks that gained prominence in this crisis) and were covered only by capital market bets, will not survive. It will no longer be possible to compensate for operating at uncompetitive legacy cost levels with a good trading desk.

Across-the-Board Transformation

In the coming months, banks will have to look beyond the immediate, short-term challenges. The institutions that anticipate the mid-term scenarios and work on their fundamentals will be best positioned to take advantage of the recovery. The world that emerges will look very different, from the regulatory environment to the pay and bonus structures,

from the ease of raising capital to the cost of doing business. The winners will be those that take advantage of the turmoil to strengthen their relative positions. A comprehensive program is required, encompassing the following five elements.

Leverage reduction

Aggressively pursue asset disposal (non-strategic, value chain reduction) and responsibly manage credit lines. This process can only be successful with a minimized impact on corporations through close cooperation with central banks and regulators.

Cost management

Engage both immediate and structural measures.

- Stopping liquidity outflow is the short-term priority. This includes possible divestitures and a review and delay of investments. Sourcing will play a key role in reducing external spending by 10 to 20 percent in the short term and managing direct spending for both general and administrative and personnel expenses.
- Outsourcing will become a structural priority for banks in order to realize immediate cost savings without bearing all the set-up cost. This, however, is hampered by the market situation.

Client acquisition

Explore both organic growth and acquisitions opportunities.

- Re-establishing trust and credibility in franchises is a first critical step. Viable organic strategies range from targeted client acquisition to selective and complementary expansion of the footprint.
- Taking advantage of suitable merger and acquisitions opportunities resulting from the consolidation wave—encouraging small, comparably less risky acquisitions and making sure synergy potential is fully exploited

Capital allocation

Carefully prioritize investment decisions in view of the expected return, underlying risk and value creation potential of each opportunity. With the cost of capi-

tal going up and the availability of capital going down, only banks with conscious and prudent capital allocation will be in a position to benefit from the upcoming market opportunities.

Government and regulator involvement

Government and regulator involvement. Work with governments as major investors to advance public relations skills. Banks that emerge successfully from this period of government involvement will be those that have tried to be perceived as good corporate citizens; made great efforts to avoid foreclosing on vulnerable debtors; contained salaries and bonuses for senior executives; and taken steps to educate their customers in the role and risks of banking. This period will pass, but while it lasts banks should learn to play by the new rules of the game and understand the new pieties.

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