



In recent weeks we have all witnessed the dramatic effects brought on by the financial crisis. Stock market crashes, frozen debt markets, bank failures, and historic government intervention have all contributed to the surreal atmosphere in the financial world and the real economy. As the events have gathered momentum over the past two years, it's become starkly clear, especially since the summer, that what is taking place is no cyclical correction, or even a secular realignment. Rather, the banking sector is undergoing a once-in-a-century transformation – a process that is right now redefining what it takes to survive and thrive in the future. With this letter, we in the financial services group at Booz & Company would like to share our thoughts on how banks should strategically position themselves for the 21st century in an epoch that will differ sharply from the one just past.

The roots of today's economic downturn are well known: low interest rates, a world awash with excess capital, misaligned incentives at banks, and a U.S. reliance on debt to drive consumption. It's also clear how a seemingly robust economy unraveled so suddenly: a slowdown in home price appreciation, consumers' struggles to service loans, and woeful risk management at many major banks. The result is a financial system that faces a *capital* problem, brought on by the impairment of assets such as mortgage-backed securities and the deterioration of balance sheets; a *liquidity* problem, created by banks' sudden aversion to risk and unwillingness to lend; and a *confidence* problem, brought on by counterparty-risk concerns, uncertainty around the government intervention, and the opaque pricing of assets.

In the face of this crisis, the U.S. government has taken dramatic action. On October 3, Congress approved a \$700 billion bailout plan to inject much-needed liquidity into the market. A month later, the government changed course and announced it would use the money to take direct stakes in U.S. financial institutions. Meanwhile, underscoring the global interconnectedness of today's financial markets, there has been unprecedented international collaboration among governments and central banks to stimulate liquidity, infuse capital into financial institutions, and restore confidence in the world's financial system.

These Herculean efforts likely staved off a total meltdown of the global financial system, but recession is here, and it will probably be deep. In many countries, but particularly in the U.S., people are rapidly coming to understand what life is like without cheap credit. Standards of living will decline for a good chunk of the population whose lifestyle teetered atop high debt loads, and lower consumption levels will have significant implications for the global economy.

These developments are leading the banking system, inexorably, to a structural transformation. In the short term, weakly capitalized banks will fail or be acquired, leaving far fewer banks standing than today's 8,000. Ultimately, the U.S. banking sector will look a lot more like other American industries. For example, the fixed-line telecom industry is dominated by three large carriers that control 65 percent of the market. The remaining 35 percent is served by smaller, virtual network operators that specialize in individual markets. In this way, the telecom industry resembles the banking industry in other developed countries, where deposits are largely concentrated in a handful of large banks.

Indeed, the government itself seems to acknowledge that consolidation is inevitable and is proactively, though perhaps not explicitly, supporting the chosen "winners" (such as Wells Fargo and PNC) with capital injections, while pressuring the chosen "losers" (such as Wachovia and National City) to find a buyer or fold. We expect the U.S. will soon have four or so major universal banks that control 40 percent or more of the deposit base. Already, three of these mega-banks have emerged from the crisis – Wells Fargo (with the addition of Wachovia), Bank of America, and JPMorgan Chase (with the addition of Washington Mutual). A tie-up between Citigroup and another major bank could quickly result in a fourth.

A combination of constrained credit availability, anemic demand, and intense deposit competition will put significant earnings pressure on the banks that remain. In the medium term, these big universal banks will seek to better exploit their breadth by shifting their competitive focus from customer acquisition to customer penetration. Given their size, it will no longer be possible for these mega-banks to move the earnings needle by stealing some fraction of a percentage from a competitor; instead, they must sell more products and services to their huge existing customer base. To do this, they will invest to improve their sales forces so employees function more as advisors who are capable of cross-selling. They will also need to upgrade their technology platforms to broaden their view of each customer and market. This won't be cheap, but the universal banks can pay for this investment by finding savings elsewhere. Specifically, they can exploit their scale to drive costs out of their back ends – for instance, in technology platforms and operations functions.

Competing with the Mega-Banks

This state of affairs is all well and good for the top few financial institutions, but what of the regional banks that must compete head-on with the universals? The uncomfortable reality is that they will face preeminent brands with funding advantages and increasingly customer-friendly offerings. For the first time, regional banks must make a case for themselves that goes beyond their standing

as the local bank. They must convey clearly differentiated value propositions to customers. To cope, the regionals have four strategic options:

1. *Build a National Franchise:* We will see more and more consolidation of midsized banks. The three or four largest regional banks that remain could combine to create a single franchise with sufficient scale to compete directly with the larger universal banks.
2. *Focus Geographically:* In countries dominated by national banks, such as the U.K., Australia, and Canada, there is always room for the underdog. Smaller banks often enjoy success by playing up their intimate knowledge of a local market or by preying on dissatisfaction with the national brands. This strategy relies on a bank's ability to deliver an integrated experience founded on superior customer intimacy. Unfortunately, many regional banks have struggled to deliver on this promise.
3. *Focus on a Customer Segment:* Another approach is to build capabilities around a specific group of customers. For example, a number of banks, such as BBVA, are outperforming the big banks with Hispanic clients in the U.S. Sunbelt. Others, such as Charles Schwab and E*Trade, have leveraged brokerage relationships into banking relationships and are appealing to affluent and mass affluent customers. USAA focuses on the U.S. military.
4. *Focus on Best-in-Class Activity:* Concentrating on a single product, such as mortgages or credit cards, was profitable in the past but it will not differentiate banks from their competitors in the future. Instead, banks will achieve differentiation and profits by creating monoline "activity" models organized around one of the three bank activities: processing, advice, or financing. For instance, State Street and BNY Mellon have built strong processing businesses based on their IT and operational excellence. In the advice realm, Lazard on the corporate side and UBS on the retail wealth-management side have excelled, thanks to their human capital and sales expertise.

Frankly, we don't believe most regional banks are currently capable of carrying out the four strategies we've listed. Their costs are too high, with a cost/income gap of 5 to 10 percent between them and the largest banks. Furthermore, the proportion they spend on back-office commodity activities is too large compared with their expenditure on products and services that matter to customers and would differentiate them. The customer experience tends to be fragmented and clunky at these banks. IT systems are homegrown and do not capture the potential of their scale. Moreover, their businesses are divided into silos or regional

fiefdoms, a condition that plays directly into the hands of the national players. It also makes major acquisitions difficult.

The case for major transformation is clear. To succeed at any of these four strategies, regional banks must develop a new underlying operating model. It must be scalable and simpler and increase focus by shedding peripheral businesses – such as mortgage operations or niche capital markets businesses that might have been pursued in boom times. This new model builds upon four crucial capabilities:

1. *Deep Customer Insight:* Build a thorough understanding of chosen customer segments to develop value propositions that customers need and that build in differentiation.
2. *Fully Integrated Distribution:* Develop a holistic, integrated approach to distribution that satisfies customers' rapidly changing expectations for how they interact with the institution. Branches will remain the cornerstone of distribution, but the Internet and mobile channels will be increasingly important.
3. *Simple Products and Services:* Create a simplified product suite that meets the needs of chosen customer segments but avoids the complexities and costs of the hundreds of duplicative products that banks now maintain.
4. *Low-Cost Back-Office Support:* In the emerging environment, anything that does not directly impact the customer experience is a commodity. Banks have had some success in driving down the costs of non-customer-facing services, but there is a long way to go. There are significant opportunities to be had in more aggressively pursuing offshoring, establishing shared services, and creating cross-organization utilities to deliver efficient services and standardize processes.

These four capabilities will help banks design more scalable operating models that can integrate acquisitions effectively and, critically, free up dollars to invest in technologies to better understand and serve customers. More than anything, these capabilities will keep the regional banks competitive with the universal banks and position them to take advantage of future acquisition opportunities.

Making the Most of the Crisis

In our view, the era of balance-sheet-driven profit growth is swiftly coming to a close. The contraction in net interest margins over the last decade, credit market illiquidity, and growing delinquencies have made growing the balance sheet to grow profits much less effective. Future success will come from focusing on P&L

margins rather than balance sheet growth – on fees rather than lending spreads. This shift will require a more holistic relationship with customers. Selling more products and attaining greater wallet share per customer are the keys to future success.

The transformation of the industry will not happen overnight. But make no mistake: It will happen as the industry copes with the challenges of survival posed by the financial crisis. The industry will be reshaped by banks' new and healthy aversion to risk – the necessary deleveraging is already occurring and will continue. Regulatory supervision will increase across the board, reshaping the industry with stricter controls on liquidity and capital requirements that will extend to areas, such as hedge funds, heretofore subject to only limited regulation.

Without question the industry faces a tough, dangerous slog. But times of great change are also times of great opportunity, and we firmly believe that no matter what size the institution, forward-thinking management teams can position their businesses for success in the new financial order taking shape. As Stanford economist Paul Romer has said, "A crisis is a terrible thing to waste."

Mike McKeon
Senior Partner
mike.mckeon@booz.com

Paul Hyde
Partner
paul.hyde@booz.com