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New Integration Rules
*The Path to Successful
Bank Mergers*



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EXECUTIVE SUMMARY

Credit market instability, lack of liquidity, distressed balance sheets, and government intervention in the financial services industry are likely to be with us for some time—and this somewhat chaotic business environment will prolong the current round of bank consolidations. These banking acquisitions, which have already produced surprising bedfellows, will result in any number of winners and losers. The winners will have something unsurprising in common: They will deprioritize short-term operational cost-cutting, hang on to value relentlessly, and build a sustainable operation via new operating models.

The banks that end up on top will also execute their acquisitions in a fashion entirely different from what was commonplace just a few years ago. They will recognize that there is little upside and much downside in rushing toward operational integration. Unlike other periods of consolidation—during which large institutions typically swallowed up relatively stable or mildly troubled smaller banks for a multiple of their stock price—there is no takeover premium that must be justified through quick cost-cutting and synergy realization. Rather, banks have the luxury of time to completely rethink and implement the future operating model. Midsized banks, in

particular, must make fundamental changes to their operating model to counteract the growing scale disadvantage versus the big banks.

Much of today's consolidation is driven by healthier banks picking up their barely surviving sisters for a song. In this situation, market fear is so great that banks must be sure to avoid even minor customer-facing operational mishaps; in the short term, such blunders could spell disaster. To be certain that acquisitions succeed in this radically different banking landscape, banks must flawlessly execute three integration imperatives across the dimensions of revenue, risk, and cost.

REVENUE: DON'T LET CRITICAL CUSTOMERS OR SALES STAFF WALK OUT THE DOOR

Bank revenue is increasingly concentrated in relatively few high-value customers. Many of these customers are nervous about their banks' solvency and are actively assessing their banking options. Customer retention is critical in any post-merger acquisition, but in the current troubled banking environment, in which every dollar or euro counts, banks must defend the deposit balances of high-value customers at all costs.

In traditional bank mergers, customer attrition of 5 to 10 percent is typical, driven by consumer dissatisfaction with the acquiring bank and branch consolidation or changes in service levels. However, this loss is usually offset by cost reduction. Today, customer loss after a merger can be anywhere from 10 to 20 percent, owing to customer skittishness about the solvency of the merging "troubled" banks and the security of their deposits. The fact that cost savings are limited in the short term compounds this problem. High-value customers are the most likely to leave as they seek low-risk, top-quality institutions in which to place their significant assets. They can and will depart at the slightest hint of instability, and they are being aggressively courted by stronger banks. Even relatively minor customer-facing operational problems—such as a glitch in the ATM network or delays in posting

deposits—could result in significant attrition of customers.

It's important to note that commercial, not retail, customers have shown the highest propensity to withdraw their deposits from the "riskier" banks in the recent crisis. Retaining these commercial deposit accounts should be one of banks' top priorities, given that they typically have higher average balances than retail deposits and are managed in a more active way.

The upside of the current environment is that customer nervousness and the desire for stability in a period of discontinuity present a unique opportunity to not only retain customers but to grow share of wallet. As the number of banks declines and credit availability for consumers and businesses tightens, banks can make a strong case to high-value customers to consolidate their holdings with a single, safe institution. The most persuasive banks will be those demonstrating capital stability, operational excellence, and an effective, relationship-based sales approach.

Customer retention depends primarily on the work of relationship managers—the top sales people and service people who have existing relationships with high-value customers. Particularly for "flighty" commercial deposit accounts, relationship manag-

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ers can be trusted advisors, touting the bank's stability and encouraging customers to consolidate their assets.

To retain the best relationship managers, acquiring banks should immediately conduct a triage exercise in which key staffers necessary for the long-term success of the organization are identified and given incentives to remain in their jobs. Employees whose presence is critical in the short term to ensure integration success should also be encouraged to stay and, if necessary, at temporarily higher salaries. Staff members without any real value to the future of the organization should be released. To make an educated decision about whom to keep and whom to let go, organizations should utilize a range of information, including performance data, internal staff recommendations, and customer feedback on staff performance.

Successful integration and retention of critical employees are dependent on a robust enterprise-wide communication strategy. Staff should be promptly informed about key decisions such as the dates that everyone will know their future roles, planned changes to severance and retirement, and senior leadership shifts. Management should also communicate the combined company's new vision through company-wide events such as town halls, Webinars, and brown bag lunches. This will also help to establish clear expectations about performance and behavior linked to business goals—such as the need to retain target customers, the tools they will have to do so, and the types of monetary rewards they will get if they are successful.

RISK: DON'T LAY OFF ALL THE STAFF WHO MADE BAD CREDIT DECISIONS

Rehabilitating or disposing of the target bank's toxic loan book is critical to preserving value. Credit staff—not formal loan databases or credit files—are likely to have the best information about the underlying credit condition of the loan book. Thus, the most important members of this group should be retained to complete the workout of the loan book. The credit staff's knowledge is significant in three areas: First, they have an understanding of the credit models, including their underlying assumptions, sensitivities, and potential problem areas. Second, they have critical knowledge of local market conditions—such as collateral, customers, and competition—especially in areas in which the acquirer has limited presence. Third, they often have personal experience with the commercial customers and high-end retail customers. Therefore, they understand to what degree customers' credit issues are based on cyclical (and temporary) lack of liquidity versus fundamental solvency issues. Once the most valuable staff members have been identified and retained, the acquiring bank should deconstruct the credit models to identify their strengths and weaknesses and embed its own level of discipline in the target bank.

COST: PROCEED SLOWLY AND GET THE LONG-TERM OPERATING PLATFORM RIGHT

In the medium term, the financial services industry is facing a massive de-leveraging of the global economy, a deep recession, and a major restructuring of the competitive landscape. This environment is likely to lead to a structural reduction in growth and margins due to reregulation of the industry affecting price, innovation, and leverage. Banks will need to fundamentally redesign their operating model, in terms of both operating efficiency and revenue capture.

Further, the rapid wave of consolidation will leave most regional banks at a scale disadvantage compared with their largest competitors, compounding the imperative for fundamental cost reduction.

Navigating this environment requires operational stability more than traditional short-term cost synergies. The good news is that the market is not expecting cost reductions to be immediate. There is time to rethink the future operating model and develop a road map to get there.

The redesign of the operating model must address three major cost categories: distribution, back office, and overhead.

Distribution redesign should include rationalizing the bank's footprint, reorganizing sales forces to build relationships with customers, and increasing self-service through ATMs, call centers, and online services. That could cut distribution spending by as much as 30 percent.

Back-office redesign should include standardizing high-volume processes and isolating them from low-volume processes, as well as consolidating and rationalizing excess capacity and duplicate activities. With these measures, banks can trim back-office spending by as much as 40 percent.

Overhead redesign involves creating demand and supply clearinghouses for corporate services and reengineering process and systems architecture. This could cut overhead costs by as much as 40 percent.

A combination of the retail and commercial banking assets of two typical regional banks would yield an asset base of approximately \$200 billion. At this size, such a merged bank would still be just over a quarter the size of the largest banks such as Wells Fargo (with Wachovia) and JPMorgan Chase (with Washington Mutual). This gives the big banks a 20 to 30 percent cost advantage from economies of scale. But the big banks will not be able to easily redesign their operating models. Their size and breadth in products, customer segments, and geography will make it harder to standardize and realign their operations to the overall organization. They are also subject to more intense regulatory oversight that may constrain more "radical" solutions. Consequently, smaller, more nimble banks that redesign their operating models in distribution, back office, and overhead functions can negate their scale disadvantage against the largest banks.

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CONCLUSION

In the current economic environment, the main objective of post-merger integration should be value preservation. This can be achieved by retaining high-value customers and staff, retaining the credit knowledge of the acquisition target's staff, and focusing on short-term operational stability and a long-term operating model redesign. Ensuring that these efforts are successful will require strong capabilities, particularly in analytical assessment of customers and staff, and experience in complex bank integrations. This must be combined with a programmatic approach to coordinate and drive the effort. If these elements are in place, acquisitions of distressed banks can deliver significant value while effectively containing the risks.

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