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Rapid Restructuring
*How Banks Need
to Respond to the
Financial Crisis*



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EXECUTIVE SUMMARY

The current crisis has shaken society's underlying trust in the financial system and has changed the banking landscape dramatically. Shareholders now expect banks to realign their mission toward long-term value creation and financial stability. While regulators have traditionally been charged with ensuring market stability, banks increasingly need to internalize these objectives as part of their own missions. The dichotomy that previously existed between the objectives of the banks and those of regulators is converging into a new set of common priorities.

Other factors are also influencing the downturn. As the market capitalization of banking stocks has plummeted, banks have been forced to pursue alternative sources of capital. The market has consolidated, and the remaining institutions need new funding models, as they can no longer depend on relatively cheap interbank funding.

The current correction in global imbalances was caused by a prolonged period of economic growth and fueled by the availability of cheap credit, which inflated asset prices. Even though such a correction had to happen at some point, it was exacerbated by a focus on short-term returns in an industry whose very nature is long-term (e.g., insurance, mortgages, and corporate debt). Increasing complexity of products, lack of transparency, and pressure to submit positive quarter-on-quarter reports led banks to take unprecedented risks. In addition, performance management systems did not always align rewards with long-term value creation.

We expect things to get worse before they get better. The recession will be prolonged, and significant additional write-offs may materialize. As a result, banks will need to respond to these fundamental changes and better position themselves for the long term.

There are seven key levers that each bank must address to emerge more resilient and able to respond to future crises:

1. Recapitalize and meet immediate funding needs.
2. Assess risks and stabilize the institution.
3. Realign the mission to the creation of long-term stability and value.
4. Refine the business model and business portfolio.
5. Optimize the cost base and operating model.
6. Align risk and performance management to the new mission.
7. Position the institution for future growth.

THE DRAMATICALLY CHANGING LANDSCAPE

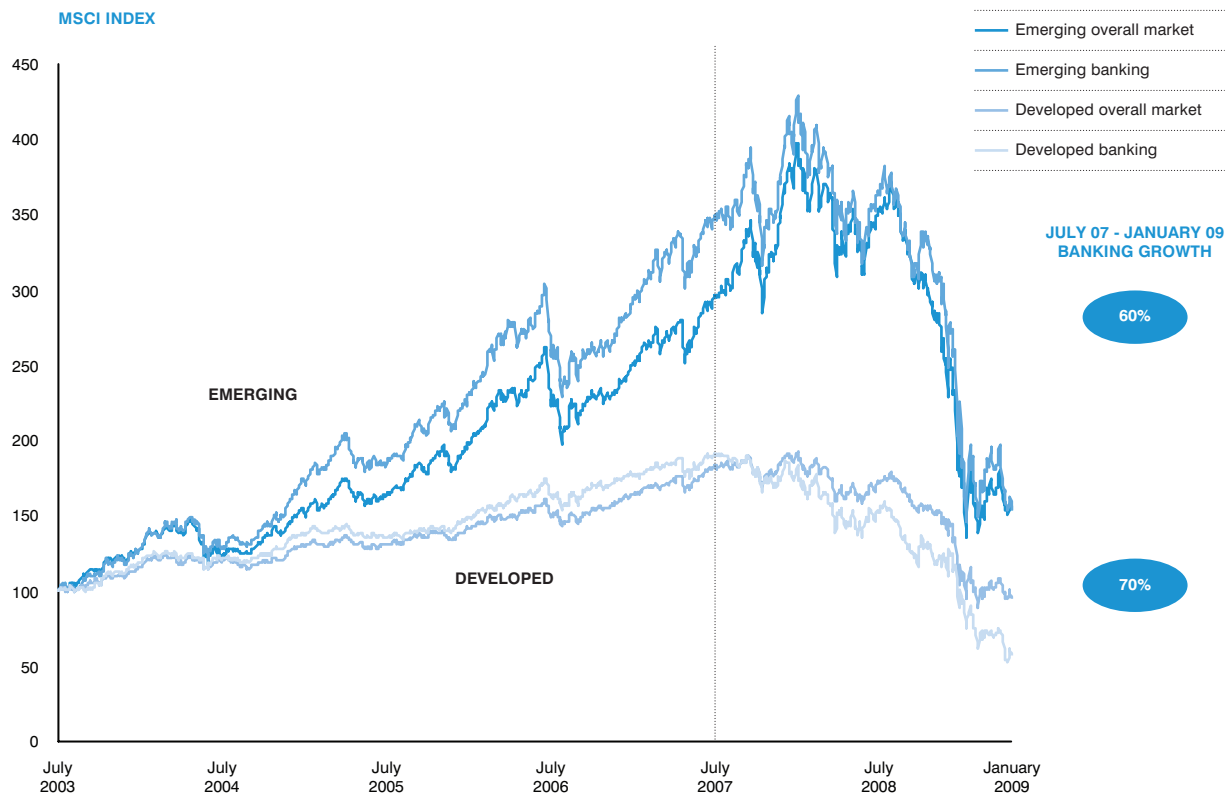
The current crisis has taken a heavy toll on many of the world's leading banks (see Exhibit 1). We have seen a rapid decline in the market capitalization of banks and insurance companies across the world, in both emerging and developed markets. Important shifts

are taking place in the new banking environment, including:

Need for new sources of capital.

The sudden and dramatic reduction in banking sector capitalization, combined with the reduced ability to

Exhibit 1
Banking Equities Performance



Source: Bloomberg; Booz & Company analysis

raise fresh capital from the public, means banks need to consider new sources of capital. As they do so, they need to take into account important trade-offs. Accessing sovereign funds could be expensive, while targeting foreign investors may result in conflicting objectives. Direct government investment may invite greater intervention, but in the future, the objectives of the government and the banks are likely to be more aligned.

New missions for banks.

The current crisis has resulted in a shift in shareholder expectations. In the past, shareholders' primary motive has been to maximize short-term value creation. This, in turn, led banks to prioritize near-term profit, focus on top-line growth, minimize excess capital, and encourage risk taking through their compensation policies. In contrast, regulators' priorities focused on building confidence in the financial system, ensuring both long-term stability and a flow of credit across different economic sectors. A shift in shareholder priorities, including this focus on long-term value creation and stability, creates the need for banks to integrate these objectives

into their own thinking. The previous dichotomy between banks' objectives and those of regulators will converge into a new set of common, longer-term priorities.

In many countries, such as the U.S., the U.K., the Netherlands, and Germany, banks have resorted to governments to fill unprecedented funding and solvency gaps (see "Government Intervention in Major Banking Sectors," page 4). Of the 10 largest financial institutions in the world in 2004, two have since been taken into state conservatorship (AIG and Fannie Mae), four have received capital injections from national governments (Bank of America, Citigroup, JPMorgan Chase, and Wells Fargo), and one has sought emergency funding from a sovereign wealth fund (UBS)¹. Even though the approach adopted by various governments has varied, government involvement in banks has increased. This further reinforces the need for banks to realign their missions toward long-term value creation and stability to meet new shareholder objectives.

Rapid consolidation.

Many major financial institutions have chosen or been encouraged

to merge with others. In many countries, the banking landscape is significantly more consolidated—for example, in the U.K., consolidation has resulted in four banks holding 75 percent of current accounts. This poses a fresh set of challenges for regulators who would prefer healthy competition in the best interest of consumers. For some banks, this consolidation has resulted in fresh growth opportunities.

Fundamental changes to the funding channels.

Historically, many banks have relied on interbank funding to boost their lending market shares. Banks like Northern Rock, which had a loan-to-deposit ratio in excess of 200 percent until early 2007, relied on these loans to operate. With the restricted ability to depend on interbank funding, banks now have to rely on alternative sources of funding, which could come at a higher cost. In general, each bank will need to fund a greater proportion of its assets from its deposit base. This will require some banks to revisit their business models, lending policies, and deposit-gathering approaches.

Government Intervention in Major Banking Sectors

Booz & Company analysis has found that governments around the world are increasingly becoming involved in the banking sector. Some current examples:

Great Britain (HM Treasury)

The British government has injected more than £100 billion (US\$147 billion) into major banks including RBS, Lloyds, and HBOS; this aid has come primarily in the form of preference shares and shares underwritten by the government. Additionally, it has made at least another £200 billion available under a special liquidity program. In return, banks have made commitments to raise Tier 1 capital, control executive compensation, and continue to provide lending to small and medium-sized enterprises and home buyers.

Netherlands (Ministry of Finance)

The Dutch Ministry of Finance has overseen a rapid capital injection of €30 billion (US\$38 billion) to Fortis, ABN Amro, ING Groep, Aegon, and SNS Bank, effectively nationalizing a large part of the financial sector. An additional €20 billion is available for other banks. At the same time, the government is exerting greater control over the banks than in the U.K. through significant changes in governance, nominations to boards, and stringent restrictions on executive compensation.

Germany (Federal Ministry of Finance)

In Germany, where banks are in relatively better shape, a more measured approach has been adopted. The government stake is set at a maximum of €10 billion (US\$13 billion) per bank, and the government can purchase nonperforming loans at a maximum of €5 billion per bank. However, even with smaller levels of capital injection, the government has set strict conditions, including limits on executive pay and direction on lending policies.

Switzerland (Federal Department of Finance)

The Swiss government has made a capital injection of 6 billion Swiss francs (US\$5 billion) into UBS. So far Credit Suisse has avoided any direct government capital injection. In addition, US\$49 billion of toxic UBS assets have been moved into a special-purpose vehicle owned by the national bank and there has been a clear commitment from banks to increase their capital base, despite limited direct intervention by the government.

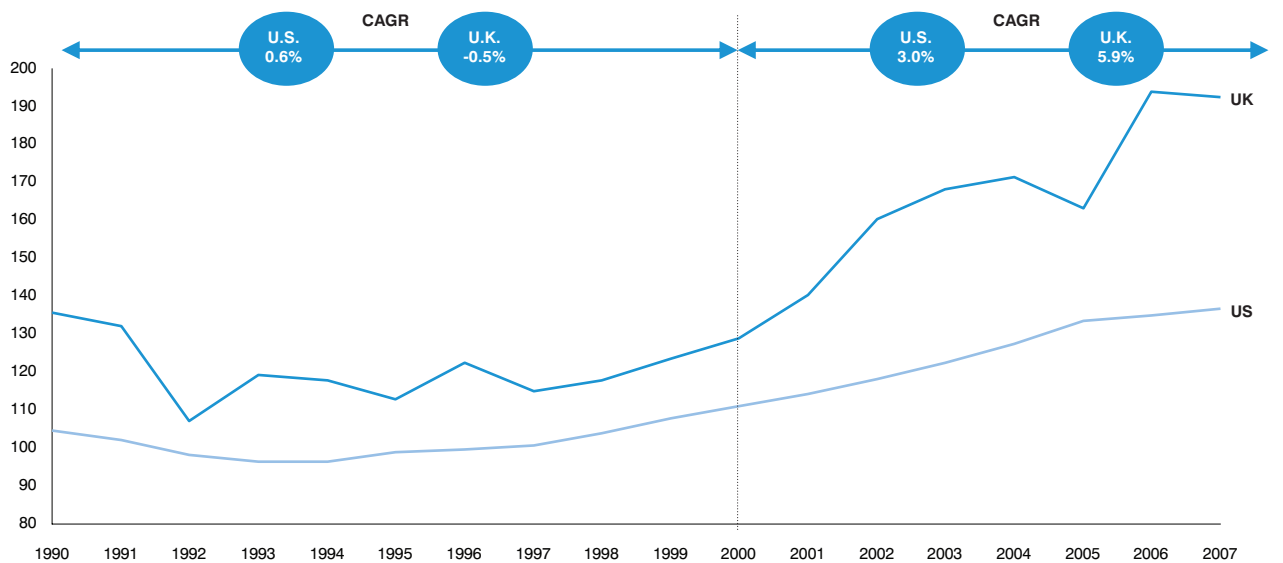
MORE BAD NEWS AHEAD

Countries around the world hold an unprecedented level of debt. The ratio of total private sector debt to GDP in the U.S. increased at 0.6 percent annually from 1990 to 2000 but at 3.0 percent annually since 2000 (see Exhibit 2). Similarly, in the U.K., it declined at 0.5 percent annually until 2000 but has increased at 5.9 percent annually since then. Given the high level of leverage in key economies, credit tightening is inevitable for a prolonged period until some rebalancing is achieved. As a result, the economy will take considerable

time to recover, meaning the downturn is here to stay for at least two years.

From a banking perspective, despite the US\$700 billion² write-down already announced across the global banking sector, we believe that many banks will incur still more losses. A Booz & Company study estimates that additional corporate debt at risk of default is between \$650 billion and \$900 billion. As a result, more banks may be at risk of undercapitalization and will need help.

Exhibit 2
Total Private Sector Debt to GDP Percentage



Source: Economist Intelligence Unit; Booz & Company analysis

THE REASONS FOR THE CORRECTION

At the macro level, the current crisis is predominantly a correction in the major imbalances that developed during a prolonged period of sustained growth, including:

- Financial institutions providing relatively cheap credit in their eagerness to ride the growth wave
- High levels of credit availability for individuals, fueling the residential real estate market to reach unprecedented property values and leading to greater reliance on personal debt
- Growth in investor demand for higher-yielding assets, leading to a boom in subprime loans, which are riskier and often come with nontraditional payment options and terms
- Rapid growth and widespread use of securitization, mortgage-backed securities, and complex structured credit products, which have limited transparency

These developments in the economic landscape also led to a significantly more interconnected world, whereby a systemic shift in any part of the global economy would have an effect on the rest. As a result, the only trigger needed for the current crisis to unfold was a correction in the U.S. real estate market. While we could conclude that this correction had to happen, excessive short-term performance pressure on banks worsened the situation by forcing them to take a short-term view in markets that are long-term in nature, such as insurance, mortgage, and corporate debt. Concurrently, executive compensation and performance management encouraged risky behavior while regulators lacked the bandwidth to predict and prevent the consequences, especially during a period of sustained growth.

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BANKS MUST RESPOND

Banks will need to respond decisively to these dramatic market changes, limiting negative impact and strengthening long-term positions. Banks can emerge more resilient by acting on seven key levers:

1. Recapitalize and meet immediate funding needs.
2. Assess risks and stabilize the institution.
3. Realign the mission to the creation of long-term stability and value.
4. Refine the business model and business portfolio.
5. Optimize the cost base and operating model.
6. Align risk and performance management to the new mission.
7. Position the institution for future growth.

1. Recapitalize and meet immediate funding needs.

The absolute priority for any bank is to maintain solvency and adequate capital. To do so, banks need to ensure

that their immediate funding needs are met and increase levels of capital, often through alternative sources such as governments and sovereign wealth funds. While weighing those options, banks need to balance the trade-off between independence and cost. Analysts do not seem to prefer one method over the other; companies that have raised capital through governments have seen their share prices fall by the same amount as companies that have pursued a capital injection from sovereign funds.

2. Assess risks and stabilize the institution.

Once the nature and magnitude of potential losses has been identified, banks need to quickly define and implement measures to limit them, such as ring-fencing toxic assets, moving assets off the balance sheet, and finding potential workouts. It is critical to free risk-weighted assets so the bank can continue to lend selectively.

Investors, regulators, and customers will need to be reassured that the bank is viable and fully solvent.

Banking management must communicate frequently with both internal and external stakeholders, to ensure that there are no nasty surprises and to minimize the chances of a run. Investors, regulators, and customers will need to be reassured that the bank is viable and fully solvent, and employees, work councils, and unions need to be informed of any potential labor implications. In addition, retention plans need to be put in place for key executives and clients.

3. Realign the mission to the creation of long-term stability and value.

As shareholder expectations change, the current divergence between the objectives of near-term profit

maximization and the stability of the banking system will have to close. It is critical to establish convergence on a common set of longer-term objectives, such as supporting the stability of the financial system, reinstating confidence (e.g., in deposit security and continuity of lending), ensuring that customers' needs are met, and long-term value creation.

In addition, given the global nature of the crisis, the mission needs to define the level of focus on consolidation within the domestic market versus international expansion. Banks need to ask themselves how much exposure they are willing to take.

4. Refine the business model and business portfolio.

Given the dramatic change in the banking sector, players need to adjust their business models and refine their business portfolios to reduce reliance on wholesale markets for funding.

Banks will need to become more self-funding. Retail banks are aggressively targeting deposits. At the same time, investment banks like Goldman Sachs have converted into universal banks, enabling them to participate in state programs and take on deposits.

To strengthen their capital positions, banks also need to revisit their portfolio strategies and make

Banks need to revisit their portfolio strategies and make bold decisions about which assets to divest.

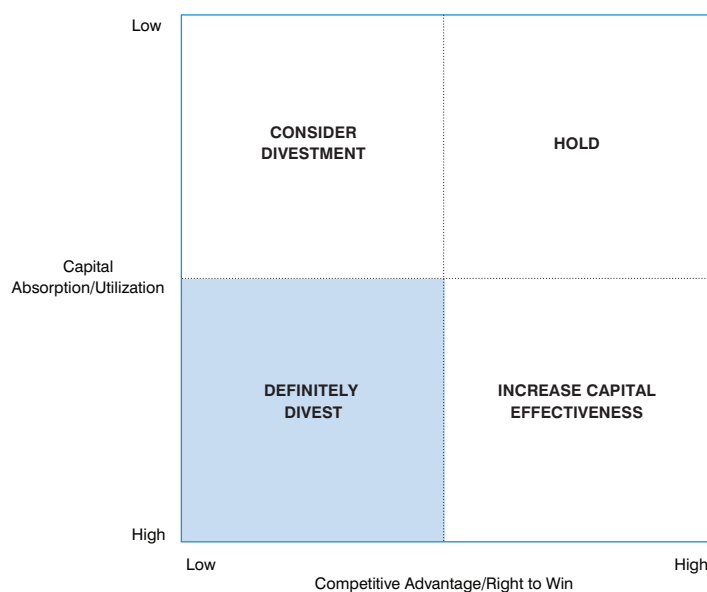
bold decisions about which assets to divest, even if those assets are profitable. Any assets that are not aligned with the mission of the shareholders, such as trust businesses for government shareholders, will need to be divested. The remaining portfolio should be assessed on the basis of two criteria: first, how much capital the bank can absorb; second, how much competitive advantage,

or “right to win,” the bank has or can build in the relevant market (see Exhibit 3). In the context of competitive advantage, capabilities are as important as assets. Assets that absorb a lot of capital and play in markets where the bank has a low competitive advantage should be strongly considered for divestment to provide much-needed capital for the bank.

In the current market environment, where there is a shortage of cash, an asset swap may be more feasible than a sale. Because some assets marked for divestment could be more valuable to another institution, banks should consider trading noncore assets for capabilities and assets they need to improve their core-market positioning, businesses, or products.

Exhibit 3
Target Portfolio Assessment

TARGET PORTFOLIO ASSESSMENT



Source: Booz & Company analysis

5. Optimize the cost base and operating model.

To generate profits in these challenging times, banks must increase productivity and efficiency without compromising customer service. In particular, as banks focus on the core, stable businesses and eschew chasing windfall gains available from riskier activities, the creation of low-cost, efficient operations will be critical to success. Banks will gain significant benefits in the medium term from redefining and clarifying their operating models. They will also be able to generate operational and IT scale by consolidating and standardizing as much as possible within and across businesses and geographies.

In the short term, banks must focus on high-yield, low-investment quick wins with attractive paybacks. They may be able to save 15 to 20 percent of the cost base through measures such as:

Increasing branch productivity: Align incentives with strategic objectives and ensure that remuneration is strongly correlated with performance.

Increasing nonbranch productivity: Freeze vacancies in all noncritical roles, rationalize support functions by eliminating duplicated activities and those that don't add value, and optimize the organization's structure by increasing spans of control and reducing layers of management.

Rationalizing project spend: Freeze discretionary spending on all noncritical projects. However, regulatory projects cannot be compromised.

Managing expenses tightly: Actively pursue both supply- and demand-side measures: Renegotiate all supplier contracts, ensuring that internal scale is leveraged, and manage demand through reducing all noncritical day-to-day expenses, such as travel.

Enforcing tight governance on all spending: Lower the discretionary expense thresholds and ensure that management tightly tracks the cost base. Management must be fully accountable for costs.

6. Align risk and performance management to the new mission.

While developing a greater focus on long-term value creation, banks must maintain financial system stability, treat customers fairly, and better meet consumers' needs. Risk and performance management measures need to be aligned with these objectives and ensure that they promote desired behaviors.

Banks must reassess their risk appetite and strengthen monitoring to ensure a solid portfolio view of risk and return. Decision making on new business must consider longer-term criteria, with processes and systems in place to ensure

Traditional performance management regimes have encouraged risk taking, as they were based on short-term measures.

adherence and maintain tight control. It is critical to establish clear accountability for risk, from the front line to the central risk organization.

Traditional performance management regimes have encouraged risk taking, as they were based on short-term measures. Banks need to ensure that their strategies are aligned with the

mission and that the organization has clear accountabilities for delivery of the strategy. Performance management measures must be aligned with these new priorities (see Exhibit 4), and incentives must encourage a greater focus on the long-term value of the business written, while avoiding any moral hazard. Adopting multiyear plans and targets that include risk metrics will help generate new

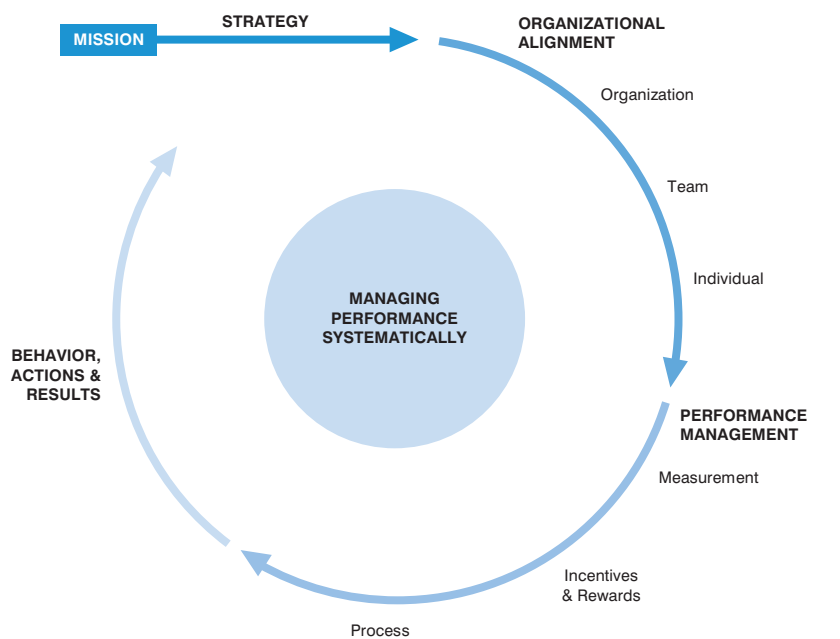
ways of working, encourage a more appropriate perspective, and ensure that the consequences of employees' actions are taken into consideration.

7. Position the institution for future growth.

In all downturns, there are winners and losers. Each bank must focus on the future and how to better prepare itself to seize good opportunities for growth.

Exhibit 4
Performance Management Framework

FRAMEWORK FOR MANAGING PERFORMANCE



Source: Booz & Company

LOOKING TOWARD THE FUTURE

Given the fundamental changes in the sector, banks need to respond rapidly. This holistic, seven-point approach strengthens every area of potential vulnerability while enhancing relationships with shareholders and customers. By addressing each in a systematic way, under the watch of senior management, banks can better weather the immediate challenges of the downturn while positioning themselves for long-term growth and stability.

Endnotes

¹ As measured by market capitalization on September 30, 2004. Other top 10 financial institutions were HSBC, Berkshire Hathaway, and American Express.

² As of November 12, 2008. Source: IMF; Bloomberg; Financial Times

About the Authors

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