

Reinventing Banking

Capitalizing on crisis



Academic papers, business books and other publications will seek to clarify what happened to the financial system in 2008. They will analyze how the sector and the world economy came to be in the position they are in as of early 2009. This paper does not attempt to do the same. Instead, we reflect on what happened only to identify the issues that senior bankers face today, and then articulate possible avenues to start rebuilding banking and, possibly, to make it stronger than it was before. While ambitious, this objective is worth a try. Merely achieving a small fraction of the stated intent will make a significant contribution to the industry and its future profitability. And the world needs a sound banking system.

How We Got Here

*“There must be some way out of here,”
said the joker to the thief,
“There’s too much confusion, I can’t get no relief.”*

— BOB DYLAN, *All Along the Watchtower*

Financial crises are nothing new. They have been around since the invention of banking in the 16th century. Land speculation and railroad financing led to crises in the 19th century. Over the past three decades, we have seen a banking crisis every five years: in 1982, the Latin American defaults; in 1987, the Wall Street crash; in 1990, the savings and loan debacle; in 1994, the Nordic banking crisis and another crisis in Mexico; in 1997, the Asian banking crisis; in 1998, the Russian financial

¹ All monetary amounts in U.S. dollars.

crisis and the Long-Term Capital Management scandal; and in 2000, the bursting of the dot com bubble and the corporate fraud of Enron and WorldCom. How can it be that once again, we are in crisis, and even more profoundly?

This crisis is deep because the global capital markets have spread it around the world, and because it came from a previously safe area in financial markets: mortgages. The numbers are staggering: between 1990 and 2007, the amount of new mortgages in the United States increased almost 500 percent, from \$500 billion to \$2.4 trillion, and the credit volume increased from \$2.6 trillion to \$11.3 trillion.¹ Meanwhile, the economy only grew by about 50 percent in real terms. This discrepancy was clearly unsustainable—but then, hindsight is always 20/20.

Money Was Cheap

Almost every crisis of the past 30 years has been managed by pouring money into the system. Either monetary easing or some controlled action by a select group of banks to absorb the losses has been at the core of each rescue effort. There were a few exceptions, for example when the Nordic countries nationalized and subsequently consolidated their banking system in the 1990s; and when Paul Volcker fought inflation in the United States in the 1980s. But essentially, losses were made easier to swallow by making money cheap. Excess liquidity has a tendency to create a bubble.

In addition, and not to be forgotten, the second half of the 1990s saw the near disappearance of public debt issuance. The U.S. administration was running a budget surplus, and in Europe the Maastricht Treaty imposed budgetary discipline on economies for which such behavior was previously unheard of, such as Italy (these countries had to improve their fiscal discipline in order to gain access to the euro). Long-term interest rates fell sharply, and investors desperately looked for long-term, low-risk investment opportunities, typically the role played by government debt. So, whereas previously between 5 and 10 percent of global annual gross domestic product (GDP) was swallowed by public debt, that money now went toward new investment vehicles. These vehicles packaged riskier credits into securities, supposedly stripped of their credit risk by the use of innovative credit derivatives. But a fundamental issue with these derivatives was never resolved: how can a single-A bond, stripped of its credit risk by selling it to a double-A institution, be equivalent to a triple-A bond? Risk quickly piled up, especially when collateralized debt obligations (CDOs) came on the market. The secondary and tertiary issues were composed of medium- and poor-quality borrowers, yet senior cash flow was

still valued as triple A, against a pool of increasingly weakening solvency.

Ultimately, this practice rendered statistical risk models useless. If you break down a large population, where aggregate laws hold, into ever-more-refined subsets, the statistical model falls apart, and single events become catalysts.

Six Unprecedented Conditions

Still, all of these circumstances should not have necessarily led to a financial crisis of this magnitude. What was different this time from the other blow-ups of the past 30 years? The significant and undetected amount of systemic risk, which triggered the crisis and caused a global financial meltdown. The following conditions help explain this:

Icarus flies. As interest rates fell, leverage became more attractive, boosting returns on risk capital and fueling bankers' bonuses. The pressure to show ever-increasing earnings in a falling interest rate environment was very real. After all, the thinking was that the worst that could happen was another little crisis that could be solved by monetary easing. Ominously, however, banks were among the most profitable companies in all sectors in terms of return on equity, yet were trading at moderate price-to-earnings ratios, indicating that the market had some skepticism about the sustainability of their profits (*see sidebar: Desperately Seeking Profits*).

Mark to what market? "Mark to market" became an acceptable accounting practice as banks' balance sheets became more of a hybrid of retail, commercial and investment banking assets, and trading became more common. Mark to market is an accounting methodology of assigning a value to a position held in a financial instrument based on the current market price for the instrument or similar instruments. It is a handy method of understanding the value of trading books and

determining the real risk they carry. But what if there is no market to mark to? If you cannot sell a security, its market value is by definition zero, no matter what your internal valuation model says. Some may dispute this, as many other assets are typically held for long periods until maturity, so market fluctuations in the interim should theoretically not affect their value. But while using mark-to-market valuation in this most recent

crisis induced losses that were not real cash losses, they were nevertheless losses, wiping out equity, and thus hurting bank stability. In addition, most valuation models assumed that the state of the market would remain relatively steady. In other words, the models were blind to sudden shocks, such as a steep drop in asset prices.

Fighting fire with fire. Financial innovation also brought some unexpected side effects. Risk in

Desperately Seeking Profits

*Some speak of the future,
My love she speaks softly,
She knows there's no success
like failure
And that failure's no success at all.*

— BOB DYLAN,
Love Minus Zero/No Limit

Currently all possible sources of profits in the financial system are either under pressure or have disappeared.

Deposits. With short-term interest rates at an all-time low, deposits' appeal are very low to customers. At the same time, the quest for liquidity puts a premium on attracting or maintaining balances. Therefore, margins can be expected to be razor thin.

Credit. The financial crisis either triggered or preceded a major global economic recession, possibly even a depression, and so credit risk has become an important issue. In addition, significant existing debts, for example those used to finance highly leveraged private equity deals, will soon come up for renewal. Correctly pricing credit is very difficult, aggra-

vated by the difficulties of correctly valuing collateral in highly volatile markets.

Money transformation. Traditionally, banks are rewarded for providing liquidity by earning money on a rising yield curve. As this curve is not very steep at the moment, revenues from this activity are low. In addition, in some cases, true yields are hard to calculate as volatile assessments of embedded credit or liquidity risk are hard to measure.

Fund management. Traditionally a highly profitable industry, its sources of profit are drying up. First, in money markets, interest rates barely cover management fees, leading either to significant outflows of money, or to fee reductions for large institutional accounts. Second, any performance-based compensation using a high watermark will not yield any contribution for a number of years, as assets are valued at half of their historical highs.

Securities underwriting and trading. New securities issues are

at an all-time low, in both the IPO (initial public offering) market and the primary debt market. Investor confidence is so shattered that it is prohibitively expensive to issue new equity or debt. The hangover from complex credit default swap (CDS) and CDO instruments is paralyzing investors at this point in time.

Payment processing. Fees from classic payment transaction processing are under intense pressure, especially in Europe. A new directive there, whereby domestic and international payment formats are now equally priced, is reducing profits from international payment transactions. The introduction of the new SEPA (Single Euro Payments Area) payment format and the need to demonstrate processing capability are driving up costs in this area. On the other hand, the card business is still in good shape, and continues to show good volume growth, despite the recession damaging consumer confidence.

securities used to be managed by simply buying or selling a security. But today, you can transform the risk of holding a share into that of holding a government bond by just buying a put option from a fellow bank. And if you change your mind, you do not even have to sell a put at the same strike value, you can simply buy a call at that value (from yet another bank, if you want to keep your position discreet). However, you are now dealing with two additional counterparties. What if one of the counterparties becomes insolvent? If everyone

All banks become like a chain of prisoners, not chained to one another in a row, but each prisoner chained individually to every other prisoner. When one stumbles, everyone falls down.

uses this kind of risk management, all banks become like a chain of prisoners, not chained to one another in a row, but each prisoner chained individually to every other prisoner. If one stumbles, everyone falls down. This is what happened in the current financial crisis.

The boomerang of globalization. In addition, capital markets became truly global in the early years of the millennium. Capital flows became more of a determinant of foreign exchange fluctuations than trade flows. The promised

benefit was additional diversification, but the spreading of capital also meant the spreading of risk. And when the risk returned through a reciprocal position, the diversification benefit disappeared. There appears to be a limit to the benefit of investment diversification, because market correlation increases through increased capital flows. The net result is the elimination of the benefit, similar to arbitrage.² Global markets live up to their name, that is, they are global, and therefore interlinked. Today, it appears that just four countries, the United States, the United Kingdom, Ireland and Spain, had large housing bubbles, predominantly financed by foreign money, which led to the spread of losses throughout the world.

A second and similar effect happened to collateral. As banks reduced the risk in their positions by requiring collateral, few probably foresaw that a value reduction in the primary risk could also trigger a value reduction in collateral, a secondary risk.

But as the crisis spread, everything became contaminated, and collateral proved to be far less valuable as a protection. This increased the initial risk position in a dramatic way.

Cassandra cuffed. Most banks have talented individuals as risk managers. The profession is about 10 to 20 years old, and counts many smart and honest people. Unfortunately, in the race for ever-increasing profits, they were often a lone voice of caution and sometimes suffered from a negative reputation for killing business opportunities. Whether they failed to convince

² *Arbitrage: The simultaneous purchase and sale of an asset in order to profit from a difference in the price.*

their colleagues on the management board, or were just employed as a token to show the world that a bank was taking risk seriously, is an open question. Regardless, it is clear that while many risk managers identified the growing risk to some degree, few were able to stop their institutions and steer them into safer waters. The temptation of profit was probably too great. Indeed, some banks went to great lengths to maximize profits without top management being aware of the risks taken. For example, Citibank issued put options on some of its CDOs to earn a slightly higher fee. When liquidity dried up, Citibank had to honor those options and \$25 billion of assets returned to its books, aggravating the bank's situation considerably.

Keep it quiet! To make things worse, when the crisis struck, institutions became miserly with information. Perhaps information systems were incapable of producing an accurate picture right away, or it could have been that banks delayed the information release hoping to ride out the storm. In the end, it destroyed the public's trust. Banks that immediately revealed all their bad news suffered a relatively lesser fall in their stock price. Institutions that denied for a long time that they were in trouble, such as Lehman Brothers, were hit hard when the truth became impossible to hide.

What to Expect

*I came in from the wilderness, a creature
void of form.*

"Come in," she said,

"I'll give you shelter from the storm."

— BOB DYLAN, *Shelter from the Storm*

Faced with all this, what is likely to happen? We can see some clear trends emerging in regulatory

controls, government intervention, rating agencies and customers.

Regulatory Tightening

Central banks and regulators must share some of the blame for the crisis. The impact of the 16-year tenure of Alan Greenspan, the fragmented regulatory landscape in the United States, and the actions of the relatively young European Central Bank all played a role. Certainly, regulators will be forced to adjust in the new era of banking. New regulations were announced at the G-20 summit in November 2008, and are expected to be defined in principle by the end of the first quarter of 2009. Enhancing regulation is never easy, as there is a need for a global consensus, which is traditionally hard to achieve. Among the items announced or expected are:

Upgrading accounting rules for derivatives and over-the-counter instruments. Really, the whole concept of valuation and risk reporting could change. Possible improvements could include importing off-balance-sheet positions onto the balance sheet, and a more blended valuation for instruments with poor liquidity. In any case, the evolution of accounting rules requires a delicate balance, as the historical value and mark-to-market approaches have well-established advantages and shortfalls. Implementing any changes could be a challenge, if judging from recent history. For example, the industry spent an estimated \$10 billion on Basel II, it took several years to implement, and even now the approach is not yet completely rolled out in the OECD countries.³ Future reforms could have an even greater scope, and it is unclear whether the industry has the financial means and leadership to implement them quickly.

Increasing transparency of over-the-counter trades, possibly by creating a global central

³ OECD = Organisation for Economic Co-operation and Development.

counterparty. This would reduce clearing risk and provide a global view of trading activity, allowing for a reduction of trading if systemic risk starts heating up. A good example of this kind of action is continuous linked settlement (CLS), which eliminated “Herstatt risk.” Herstatt Bank was a private German bank that was liquidated suddenly, leaving a huge overnight foreign exchange payment undelivered. By continuously and immediately settling foreign exchange transactions, CLS has put an end to this kind of overnight exposure.

In addition, position management in derivatives and swaps may require more transparency. As we described earlier, it is possible to build positions with counterparties so that a controlled net position may have several gross obligations. It will be interesting to see if regulators conclude that positions can only be reduced by rolling back the original contract, and not by engaging in a mirror transaction.

Making the scope of regulation consistent, as a significant part of the financial system escaped proper regulation, such as hedge funds. Brokers may also warrant more regulation, especially in the United States. Finally, there is the blurry landscape of special purpose vehicles, which could be forced into more proper prospectus publishing to warn investors of their risk. However, correctly labeling a case of nuclear waste as “very toxic” does not make it less hazardous. Regulators may take a broader view of the notion of risk, and upgrade their scope accordingly.

Tightening practices such as lending, since one of the causes of the credit losses was the decoupling between origination and holding of credit risk, leading to a blurred relationship between risk assessment and risk carrying. In addition, many banks entered into massive share buyback programs, effectively reducing their risk

buffers. Bank of America, for example, made a total of \$86 billion in share buybacks over the last five years. Regulators need to determine how banks will balance the need for optimal capital structures with the need for sufficient equity.

Screening bank governance in terms of risk and profit, and executive qualifications and compensation. While corporate governance progressed significantly in many countries following the Enron debacle, there may be more work to do. Many risk managers saw the crisis coming and they have stated how tough it was for them to convince the executive board. We have learned that risk awareness should be as much a part of a banker’s DNA as commercial astuteness. The debate around compensation is merely a consequence of the public outcry against lavish bonuses being awarded to managers of now bankrupt or bailed-out institutions, while consumers take the losses. Pressure to intervene in this area is huge, and countries such as Germany have already acted. It is far from proven that such a policy can be effective. While compensation practices may have gotten out of hand, capping is difficult to enforce. Alternative consulting schemes or relocation of top management to unregulated jurisdictions are easy workarounds.

Controlling fraud and toughening sanctions for those who do not act honestly. After the unprecedented scam by Bernard Madoff, this almost becomes inevitable. Given the notoriety and magnitude of the scandal, many politicians will be motivated to intervene.

Building global cohesion. Capital is extremely mobile, and if only a few jurisdictions abstain from the tighter but better regulatory principles, their benefits will be negated. Ensuring global compliance is historically difficult. For instance, the Financial Action Task Force has been very successful in promoting anti-money-laundering

practices, but a few jurisdictions have explicitly chosen not to comply. Just as the fight against global warming must be intrinsically global to be effective, so must financial regulation. Only a return to fixed exchange rates and the gold standard would take away the need for global regulation, but this would likely create other disadvantages for the world economy.

Government Intervention

World governments have already intervened by providing additional protection to consumer savings, and by recapitalizing banks. Governments want to protect consumers and prevent a complete meltdown of the financial system. As the smoke lifts from the battlefield, the different techniques used by different governments will be judged on their effectiveness. In the short term, the banking sector is in many cases partially under public control.

Government control will raise a number of questions in terms of industry structure, governance and innovation. In particular, what is the long-term role of government as a shareholder? How long should the government remain a shareholder? Since the role of central banks as lenders of last resort is limited to providing liquidity, will government have to be the investor of last resort to sustain solvency? Government guarantees are perhaps not the most effective way of doing this, as they are very costly to taxpayers and inspire little additional management discipline. Preferred equity or subordinated loans strengthen the capital base, provide some return for taxpayer money,

preserve shareholder voting rights, and do inspire management discipline. Straight equity participation or effective nationalization is somewhat cheaper for the bank than preferred equity, and offers the government possible long-term value gains, at the expense of current shareholders.

Many advocate the creation of a “bad bank.” This is a somewhat separate issue, which we discuss in *The Good, the Bad and the Ugly* on page 8.

Rather than determining bonuses at year end and paying them out immediately, a compensation system could be designed with bonuses vesting over time and only being paid out over time.

Cautious Rating Agencies

The current crisis brings an old conflict of interest to light, that of rating agencies being paid by the institutions for which they provide a rating, leading to errors in judgment. Rating agency emails exposing this practice have garnered negative publicity over the last year. It is likely that the role and purpose of rating will have to be examined, with rating activity financed in an alternative way, possibly by investors or regulators. Or, regulators may step in to provide these services themselves, funded by the proceeds of transaction taxing or other public funding mechanisms. However, overcautious behavior by rating agencies will delay economic recovery.

Suspicious Customers

Confidence is shattered. Banks are struggling to decide what to offer customers and how to build a credible story. Even when properly capitalized, tightly regulated, and led by seasoned executives with acceptable compensation, why should one trust a bank again? It is likely that product innovation will become more difficult, as the public appetite for new investment products is very

low. (Or will greed surface again over the next three years?)

In short, the banking industry is on parole. Its supervisors and customers will scrutinize every action. But this is not really the time for doom and gloom. The world economy and every consumer need a properly functioning banking system. The problems are not existential, but behavior-driven. What can banks do to restore

The Good, the Bad and the Ugly

*You must leave now, take what
you need, you think will last.
But whatever you wish to keep,
you better grab it fast.
Yonder stands your orphan
with his gun,
Crying like a fire in the sun.*

— BOB DYLAN,
It's All Over Now, Baby Blue

Many experts have called for the so-called “bad bank” solution to fence in the current problems and continue with the “good” banking business. This form of absolutism is attractive, as the books of many banks look quite ugly right now.

The bad bank approach successfully solved crises such as *Crédit Lyonnais* and *HypoVereinsbank*. In both instances, the size of the problem made it relatively easier to manage than today's crisis. Even so, it took several years in order to sufficiently understand the problematic loan portfolio of each bank and provide an acceptable valuation.

In essence, the creation of a

bad bank out of a single institution is nothing more than a spin-off. For example, imagine that General Electric wanted to sell off GE Capital to the public. It could be easily done, provided the assets of GE Capital could be valued. And this is precisely the problem with using this approach to solve this crisis.

The first challenge with creating a bad bank is determining which toxic assets or loans must be isolated, and also defining what exactly defines “toxic.” The repetitive slicing of loan portfolios into CDOs (simple, squared or cubed) makes this difficult. Wholesale dumping of loans is not possible as the size of the bad bank would become prohibitive, with few good assets left.

Second, valuation of assets and loans is problematic. While foreclosed houses are worth something, the value is difficult to assess, and fluctuates. If bad assets are overvalued, the bad bank may require additional capital, possibly from the government, which would solve nothing. If the bad assets

are undervalued, the government may need to recapitalize the good bank, as most existing capital would be needed to take the write-offs on the bad loans. Only after the dust settles will valuation become easier, facilitating the creation of a bad bank.

Third, the eligibility of each institution is an issue. Governments are shareholders in many banks, but fairness requires that creating a bad bank should not be limited to only those banks. If excluded, banks which suffered only mildly in the turmoil would be punished for good behavior. But a blanket measure could create a huge institution, with a balance sheet equivalent to the GDP of the home country. The challenge of liquidating these large portfolios is considerable.

Probably, bad banks can help to solve any remaining problems once the banking system has regained some form of stability and profitability. It can be an elegant way of cleaning up the tail-end of the bad assets, probably in the context of dressing up the remaining good assets for sale.

confidence and earn the right to be the guardians and cultivators of society's wealth once more? This question is relevant to each (surviving) bank, whether its shareholder is named Gordon Brown, Warren Buffet or John Doe.

This paper tries to offer some ideas. Some of them are not new, but merely an upgraded version of existing ideas or trends, which have become more relevant given the current crisis. Others are somewhat more innovative. These ideas are confined to retail and corporate banking, but they are also relevant to private banking. The investment banking function is discussed in the appendix, *The Future of Investment Banking*, on page 22.

Seven Possible Avenues

You lose yourself, you reappear

You suddenly find you got nothing to fear

— BOB DYLAN, *It's Alright, Ma (I'm Only Bleeding)*

It is not the end of the world—banks will emerge once more. The issue pressing top management is how to accelerate this recovery and build stronger institutions. And now may be the right time to do so. The regulatory environment and the practice and system adjustments it will bring are identical for all. The situation is similar to a car race, brought to a halt by the safety car because of a major accident. Smart drivers go into the pit lane to change tires and get fuel, because in these circumstances, it may be easier for them to catch up after the pit stop. This is exactly what banking executives should be thinking about: what can be done now to strengthen the bank? And quite a lot can be done. The following are offered as interesting actions to think about.

1. Rethink Risk Management

The banking industry's risk management function was perhaps able to see the disaster coming, but unable to avoid it. Arguably, there may have been no hiding, since systemic risks may have been so profound that nobody could totally escape the crisis. But a lot could have been done to contain the impact on individual institutions. Rethinking risk management means action on a number of fronts:

Ensure risk appreciation is a shared top management responsibility. Rather than considering risk management a specialized department, banks should make risk management part of each area of management, with the risk management function acting as a coach and central knowledge repository. This could entail setting up key performance indicators that reflect risk in a more appropriate way. These “circuit breakers” could stop risky practices before they got out of control. In addition, banks could institute real-time position reporting to regulators, which would function in the same way that air traffic control systems use radar to keep an eye on each plane's position.

Make variable compensation reflect results. Rather than determining bonuses at year end and paying them out immediately, a compensation system could be designed with bonuses vesting over time and only being paid out over time. As heretofore undiscovered risks materialize, they would be deducted against amounts payable. In practice, bonuses before risk impact could actually be higher than today's, as they will capitalize during the vesting period. The pool of vesting bonuses could also act as a capital buffer of some size if this system is widely adopted within a bank, as bonuses are typically a sizable proportion of total costs. For example, for Goldman Sachs the bonus pool was typically \$3 to \$6 billion per annum. Imagine half of that being reserved during

a three- to five-year period. It would have created an equity cushion of \$10 to \$40 billion, twice the capital of the bank.

Adopt alternative models to assess risk.

Most classic risk models are derived from thermodynamics, and describe a system in equilibrium. Yet a systemic risk crisis is by definition not in equilibrium. Different models are needed that describe much more extreme circumstances, and top management needs to think through extreme scenarios in a simple way. Many advanced modeling techniques are being discussed in academia beyond the Gaussian distribution-driven value at risk, which is quite simplistic in extreme circumstances. Use of power series or other modeling techniques that cope better with extreme behavior may be the way forward. There is a common fallacy of mark-to-market accounting: you can sell your assets at the price of the last transaction. Yet every trader knows that every block trade influences the market price (hence the use of liquidity discounts in such trades). In good market circumstances, mark to market overvalues assets that need fast liquidation. In bad times, it undervalues assets, as investor fear creates abnormal amounts of selling. It would be as if everyone was forced to sell their personal stock portfolio at the end of each trading day, and then had to reconstitute it the next morning when markets opened. Stock markets would alternately freeze and boil. We need better models to take these extreme circumstances into account.

Apply “war games” to simulate a crisis.

Military forces use this technique in peacetime to simulate a crisis, keeping troops alert and ready to react. This type of exercise may be especially fruitful as every financial crisis has had a different cause so far. A precise repeat of the circumstances that led to the 2008 meltdown is unlikely to happen. So rather than drilling for a specific

scenario, these exercises should reproduce a state of generic risk. Central banks and certain global market infrastructures have already started this practice as a response to the terrorist attacks of September 11, 2001.

Seek reinsurance against the capital base.

Banks could try creative ways to strengthen the capital available in times of distress. For instance, they could raise capital by selling future rights to shares. Earnings dilution may be lower than anticipated. Of course, it may be easier to sell these rights during good times. Such an idea needs meticulous development, as it comes at a cost to existing shareholders, and holders of these rights should typically not be part of the traditional banking system (reinsurers could be a target group). It is also important to note that this plan resembles the system adopted by Lloyds of London until the reinsurance crisis of the early 1990s, so it is not immune to severe crises either. Nevertheless, a careful and moderate use could help strengthen the bank. One example of successful use of this tactic is in Spain, where the central bank forced its supervised banks to hold special equity reserves. As a consequence, Spanish banks weathered the crisis relatively well, and the situation in Spain is now regarded as a role model for the world.

Demonstrate improved risk awareness.

Those who adopt improved risk management practices and effectively communicate that through investor relations may gain an advantage. It is well known that excellence in financial reporting lowers the cost of capital, even in good times. Smart disclosure about these practices could contribute to restoring investor and customer confidence. During the recent crisis, banks that disclosed the nature of their losses early on, and took appropriate actions, suffered less of a stock price decline and are ahead on the road to recovery. UBS is a good example.

2. Redefine Business Scope

Many banks suffered losses in products where they had little tradition, or where the market was hardly suspecting them to be active. While some of this may be due to excellent salesmanship by major league investment banks, it raises questions about the stated versus actual business scope of banks. Banks that stay within their true scope of business may be less likely to suffer catastrophic losses.

The use of equity as a risk buffer could change. In banking, equity stands as a generic risk buffer, covering all sorts of risk across product lines. This differs from insurance, where each product line has its own equity, and is explicitly forbidden from transferring reserve from one domain to another. This difference stems from the unique nature of each business. In insurance, risk is divided into pools and priced appropriately using the annual premium. In banking, banks price risk based on different customer groups, by paying a lower interest rate to short-term depositors and higher interest rates for longer-term accounts.

Also, the players could change in the aftermath of this crisis. For years, further consolidation in banking has been anticipated, and to some degree has happened, with the emergence of large international banks such as Citigroup and HSBC. But it turns out that some of these institutions that were deemed “too big to fail,” either failed or needed rescuing at a very high cost. Institutions that pursue a more focused approach to expansion, per line of business, could have a lower

systemic risk. Smaller and more specialized players could command a premium from shareholders as they are more transparent and less prone to risk. But banks should not be blind to opportunity: in the aftermath of such a crisis, there may be attractive merger and acquisition targets.

Radically changing everything because of the financial crisis will not be credible with customers. Maintaining the brand message with some modulation appears the best way forward.

What to do will be different for each financial institution, but it is certain that now is the time to come to grips with these issues around business scope. Banks could embark on this journey by:

Focusing on core competencies to boost long-term shareholder value. Some institutions with a strong focus weathered the storm well. For instance, the Bank of New York’s custodian business may have suffered in profitability, but that line of business is relatively recession-proof. Rabobank, which focuses on agricultural trade, including the commodities business, has emerged as the only triple-A institution still standing. In both cases, the bank understood its core competency and ruthlessly pursued it. Bank J. Van Breda is another example, in that it systematically seeks to serve professions such as doctors and

lawyers. It does not engage in pure retail and corporate banking. It has confined its activities to a geographical area where it understands the regulatory framework and the economics of these professions really well. It has produced above-market returns now for a number of years. It separated its security brokerage business a few years ago, but it serves its customers well, with financial products, insurance products and plain good advice on how to develop their professional activities, leading to unprecedented customer loyalty.

Institutions that move away from their competencies risk problems. HSH Nordbank is a leader in shipping and aviation services, and its trouble came from diversifying into esoteric credit derivatives. Similar things happened to AIG; the core of its insurance franchise is untouched, but it had a specialized activity insuring credit risk, which accumulated \$400 billion of exposure. Even though AIG wanted to curtail the activity as of 2005, it had grown too big to dismantle quickly, and the rest is history.

Understanding capital needs of each line of business. The capital needs of specialized businesses may differ greatly. For example, the cyclicity of aircraft leasing is relatively well understood, as supply is determined by the delivery time for new aircraft, and the products have a long life cycle and are well standardized. Managing demand is the real risk, but can be accommodated given the nature of the product. So, what is the true capital need as a risk buffer? And can the business be isolated from the broader capital markets, making it immune from liquidity fluctuations? For example, given the long life cycle of aircraft, could this be funded with proceeds from pensions, with the contributions of relatively young workers? Even in the worst of crises, they are unlikely to call in pension reserves, as tax regimes make this very expensive.

To examine a different business, what are the capital needs of banks that seek to attract the savings of older people who primarily want an annual income stream and to ensure the tax-efficient handover of their savings to their heirs? Banks may want to find out if this business can be made relatively price insensitive, with assets parked under bank custody, owned by heirs and income allocated to the aged. There may be creative ways to isolate discrete amounts of capital and have a properly funded business without depending on volatile capital markets, effectively shielding the business from incidents in those markets.

Adjusting structure, financial reporting lines and governance to reflect changes in business scope. When a bank focuses on the core business, and creatively designs its business to have a relatively secure capital base as a risk buffer, it has to adapt organizational structures, governance models and compensation systems to fit. One of the key challenges is to credibly communicate the risk-adjusted returns to the market. This will require excellent reporting systems. Some institutions have been able to do this. Take Macquarie Bank, a global lender in shopping center financing. Although it was not totally immune to the recent crisis, it has weathered it better than others, as it was able to explain to the market its superior understanding of commercial real estate. Part of its success derived from its excellent financial reporting system, which included incentives that followed the dynamics of the business. Equity markets allocate a premium to the stock of businesses that can communicate this competitive advantage.

Identifying attractive targets with similar business scope to strengthen the position. Once the institution is on the new path, it can consider whether to acquire other lines of business or even institutions in order to grow. These acquisitions should be in line with the focus area, replicating

the core skills that the bank has chosen: superior economies of scale, as Bank of New York is doing in custody; superior customer service, as Bank J. Van Breda is doing; or superior asset class understanding, as Macquarie Bank is doing.

Disposing of unattractive business lines.

As a natural byproduct, activities that no longer belong in the core of the institution should be disposed of. But timing here is everything—with current asset prices where they are, it may be a good time to buy rather than sell.

Using outsourcing whenever beneficial.

Outsourcing will begin to become a more attractive option for many business functions. For example, if an institution's competitive advantage is centered on quality of advice and customer service, then it should examine the possibility of outsourcing functions such as the securities brokerage, payments processing, mortgage processing or loan servicing. Outsourcing is not an easy process, and possibly the hardest part is fully understanding the requirements for system architecture for the bank. In fact, outsourcing is sometimes the catalyst for adopting a service-oriented architecture, which dramatically simplifies the number of interfaces between systems. Outsourcing requires carving out a block of functionality, which means rethinking how this functionality can be accessed in a simple way. These issues have driven institutions such as ING to invest in a more service-oriented architecture approach.

Another advantage of outsourcing is relief from regulatory changes, if service providers use solutions that are then leveraged by multiple customers. This shields the bank to some degree from regulatory hygiene functions such as anti-money-laundering controls, which are necessary but not a source of competitive advantage. However, outsourcing will in general not discharge banks from their regulatory responsibilities; it

will merely relieve them from the burden of the implementation.

A good example of redefining business scope is UBS, which was among the first to see its capital wiped out, in March 2008. It quickly split the bank into three parts (defined its core business), changed the cost of internal funding (adjusted its capital allocation), and improved its governance and organization. It communicated clearly and humbly about it all. Customers for the most part stuck with the bank, and UBS was recovering nicely during the last months of 2008.

3. Reinvent Products

Financial products are in essence simple: you either put money in or take money out of the bank; you get or pay back somewhat more. Alternatively, you buy or sell a security, and the bank takes fees of various types to sell or buy them and safeguard them. It sounds like the ultimate commodity business. Banks can only vary the interest rate, the ways of collecting or paying back the money, and a few other contractual items. Institutions may want to explore ways to make the products more appealing, by either using affinity as a concept, or by bundling various items (some attempts have been made with credit cards). The following are some possibilities:

Using affinity and emotions. Recently, an Australian bank launched a savings account for its employees where the interest rate varies with the results of a broad customer satisfaction index performed quarterly by the bank. Banks could broaden this “affinity” concept to external customers, whereby a corporation could have a cash management account with a bank, but could also have a variable interest rate for its employees following a predefined key performance indicator. The extra interest could be taken from the interest on corporate cash, creating a possibly tax-efficient

funding. Or banks could launch a series of affinity-based savings accounts, whereby part of the interest goes to a designated charity. Any tax break for donations could be included. Or banks could offer a savings account where the balance can be drawn upon by the account holder's favorite soccer club for credit. Affinity, emotion and loyalty can be used much more to define products.

Bundling various products. Mortgages have been bundled with investment schemes, to optimize the tax shelter of interest deductibility. But banks could take this concept further and include,

offer a bill handling service, with periodic reporting to the responsible next of kin, to help people pay their bills on time. Or alternatively, banks could offer savings plans for grandparents with an automatic contribution to grandchildren on their birthdays, coupled with some life insurance. Banks could even extend this concept to a charitable assisted living product for the needy, whose income depends on welfare.

One of the biggest emerging trends is succession planning. New concepts such as the family office are able to systematically analyze people's assets and the best way to transfer them to the next generation. While this type of advice is of course valuable to people, it is also important to banks, in order to prevent assets from disappearing to another financial institution. There has never been more wealth to inherit than there is today, which makes succession planning a particularly important trend, especially with the most valuable customers in terms of net worth.

There has never been **more wealth to inherit than there is today,** which makes succession planning **a particularly important trend.**

for example, fire insurance or a savings provision for future refurbishments. Or there could be a monthly budget for automatic utility payments, with a settlement of any resulting differential at the end of the year. Creative bundling is another way of developing unique, attractive products.

Assisting customers throughout life. Bundling can also be customized to fit a certain period of a customer's life. For example, as the population is aging, many people are still enjoying relatively good health, but often are no longer able to control their finances, having left this to the next of kin. These relatives often live far away, which makes the affairs difficult to manage. Banks could

Banks that experiment with their product lines may find the effort worthwhile. With IT support to determine parameters and quick test marketing, great ideas that attract new customers can be brought to market. Now is the time customers are rethinking their existing banking relationships, and they may be willing to switch.

4. Rebuild Brand and Trust

Clearly, people care about their money, even more on the deposit side than on the credit side. Trust is everything in the relationship between banker and customer, and it has been shattered. Possibly not only trust in individual institutions, but in the

system as a whole. There are no miracles that will rebuild the relationship and the brand, but here are some ideas of what can be done:

Maintain continuity in message. Brands take years to build. And consistency is probably their most important attribute. Brands such as Visa, McDonald's and Coca-Cola stand for predictability and experience, and banks' brands have lost these qualities. However, radically changing everything because of the financial crisis will not be credible with customers, either. Maintaining the message with some modulation appears the best way forward. For example, UBS' "You and Us" campaign focuses on building the private banking business. Its message became somewhat tainted after the announced losses, but UBS maintained the communication using the same style of advertising, but changing the message slightly to "Times may change, but the relationship remains." It was probably the right blend of consistency, while being sensitive to the impact of events. Continuity combined with humility seems to be the correct tone.

Seek emotional appeal. The limited spectrum of branding techniques used by banks is remarkable. Advertising typically is limited to name advertising, possibly adding messages of global coverage or local knowledge. At best, an award the bank won might be advertised in a professional publication. Banks could expand their advertising into the realm of celebrity marketing. Cosmetics and luxury products have adopted this technique successfully. Though celebrity marketing always antagonizes part of the customer base, this is equally the case for other industry sectors, so there must be more that can be done. Many banks support foundations for the arts and sciences or charities, and while one should never make cheap appeals based on these activities, the notion of a caring pillar of the local or global community can probably be brought into the public eye more effectively.

Apply total disclosure in press and investor communications. Clearly, people are too savvy these days, and they have access to too many information sources, for them to be fooled about a bank's financial condition in the long term. And even if temporary silence about hidden losses can buy time, it is equally clear that the impact of late revelation will be far worse. Excellent communication with the press and investors results in a share premium, even more so in today's turbulent times.

Rebuilding brand value and trust is an art, not a science. With shattered customer confidence, no miracles can be expected. But, with the right mix of consistency and humility, and possibly some creative techniques, banks may be able to accelerate the process of earning customer confidence once more.

5. Do Real Marketing

For a number of years, banks have been struggling to find more effective marketing. Customers are weary of broad-based, poorly targeted direct mail campaigns, advertising another credit card or the latest mutual fund. A newer, better practice is event-driven marketing. Banks have actually been doing this for years; for example, offering car financing with attractive rates at major car shows. But there is much more that they can do.

After all, the need for financial products is for the most part event driven. For retail customers, it has to do with moving, buying a house, changing jobs or other events in the family. For businesses, it has to do with buying machinery or expanding commercial space, hiring people or buying another business. Understanding when these events are going to happen and possibly anticipating them makes for great targeted marketing.

Another aspect of targeted marketing, and one of the true innovations of Internet search engines, is the mass of information on people's

habits that a search engine operator collects. While this is a major concern for privacy watchdogs, the concept is interesting from a marketing perspective, and many banks have developed appropriate techniques to collect customer information while respecting privacy. The following are some ways banks can improve their marketing:

Think through demographic and publicly available data. The principle of using demographic information in marketing is well known. For instance, when a young person turns 18, the time may have come to go to university, and therefore new financial needs may emerge. There may be more sophisticated demographic patterns, such as professional affiliations, where a targeted campaign may make sense. European applicants for a student visa in the United States may need to have a bank account there. Banks might want to target alumni from a particular business school. A restaurant owner approaching the age of 60 may be seeking to sell his or her business. A small business seeking renewal of a license (often public information) may need an investment loan. Export statistics may indicate a need for documented credit for particular companies. In short, there are a plethora of combinations to be considered, often based on publicly available data.

New patterns of behavior may reveal a financial need that a bank can market toward. For example, a customer could be a regular buyer or seller of antiques on eBay, handling fairly large amounts of cash. A dedicated account, including a credit facility to enable the customer to pick up unexpected bargains he or she finds online, could be beneficial. How do banks find out about these behaviors? Participation in a financial discussion group on LinkedIn may reveal an unknown preference to trade in stocks. Marketing ultimately comes down to how well a business knows its customer base.

Understand patterns between consumers and business. Understanding consumer habits starts with understanding peoples' salaries, but it may be worthwhile to examine bonus payout schemes. At large corporations that employ thousands of people in a given area, a micro-segment may arise where the investment of bonuses in mutual funds could be done at reduced load fees. This may have a particularly high response rate in a relatively homogenous group. Another possibility could be a company car approaching the end of its lease, and the driver (employee) could be interested in acquiring the vehicle as a second family car. This would make sense to the driver, as he or she knows the car's history better than anyone else. Another idea could be to pay employees a small bonus or other payment on anniversaries of 10 or 20 years of service.

Collaborate with independent advisors. Independent financial advisors often have a lot of influence with their clients. Tax experts and accountants are often uniquely familiar with the financial situation of professionals or small business owners. Banks have effectively reached out to these advisors with referral programs, but these could be deployed in a more systematic way.

Encourage customers to share events in their lives. Effective marketing is often the result of finding out about upcoming events before anybody else. For instance, a bank could offer a new grandparent a small gift for the child, such as a savings account with 20 euros. The more communication between the bank and the customer, the more the bank can anticipate life events with a tailored product offering.

Understanding that financial needs are driven by events may seem simple, but to think through how to spot these events and what types of service offerings can be proposed can be a painfully systematic exercise. Having a well-

developed process to identify possible data sources, while respecting consumer privacy, will help significantly in targeting customers with the right product. Ultimately, understanding what is going to happen in a customer's life in a great way of strengthening a relationship and becoming a trusted advisor.

6. Rearrange Distribution

The proper distribution of banking channels is an old issue. While traditional branch structures appear expensive and have been predicted to disappear many times, they are still, albeit in a restructured way, vital to the proper functioning of the bank and the building of personal relationships. The issue is not resolved, however. Buying patterns, especially those of young consumers, continue to change, so the appropriate structure of distribution channels (call centers, websites and traditional branches) also continually changes. Here are some suggestions on how to improve distribution channels:

Understand the needs of the Internet generation. Young customers have grown up with the Internet, and for them the technology is part of everyday life. They want instant gratification of their needs and they are well networked over the Internet and immediately tell their friends about their experiences. This means two things for banks: 1) they must be able to develop an immediate answer to questions coming in over the Internet, and 2) they must expect good or bad experiences to be amplified over the Internet. This means that the bank's information systems should be able to keep track of all contact points with the

customer, be it over the Internet, in the branch or through a call center. Information systems will have to evolve in order to cope with this need.

The Internet will eventually take over as the distribution channel of choice. Its use for transactional banking is highly correlated with the penetration of broadband Internet connections in a given market. In some countries this is more than 90 percent, with more than 80 percent of

People are too savvy these days, and they have access to too many information sources, **for them to be fooled about a bank's financial condition.**

consumers using Internet banking for simple transactions. However, legal requirements, such as knowing the true identity of a customer, or more complex transactions such as mortgage applications, still require a physical branch infrastructure.

The consequences of new technology could have a long reach. Person-to-person payment systems such as PayPal are already quite successful. Person-to-person loan services are also emerging. During the typical innovation process, only a few sustainable business models emerge after a wave of frenzied innovation, so banks face the question of whether it is prudent to engage these new concepts at this time. Equally, regulators face the question of how to ensure desired protection levels in this new area.

Handle cash. While there will be a need for branches, providing security makes them costly, given that they may contain personal vaults and relatively large amounts of cash. However, today cashless branches are no longer impossible. Personnel can simply access ATMs using special cards to withdraw or deposit the necessary cash. In this way the associated security cost for the majority of branches can be reduced to that of an ATM network. In fact, by limiting the availability of personal vaults to main branches and by correctly pricing for them, that service could become an attractive business line in itself. Many private banks, such as Lombard Odier, have deliberately chosen to stay out of the current account business, and therefore do not have the burden of cash or transaction handling.

Optimize branches. The debate over the proper role of branches continues to rage. Focused single-channel institutions, such as Egg or ING Direct, have been cited as examples of how to grow without a costly branch-based infrastructure. On the other hand, as these focused institutions try to grow, they often have to open up branches to serve more complex customer needs. Branches should be thought of not as supermarkets, where people come for multiple daily needs, but more as apparel boutiques, where people want to receive advice on what suits them. After all, most people make fewer financial decisions than they do grocery decisions.

Clearly, the role of branches is twofold: to advise customers who need it; and to assist those customers unable to use self-service options such as call centers or the web. Branch systems can be essentially similar to the online channel, with branch staff simply authorized to do more than customers are able to do on their own. In the same way an LAN (local area network) administrator in an office has identical infrastructure as other

network users, but enhanced access rights, bank staff can initiate transactions or product purchases on behalf of customers through a simple laptop, and even withdraw cash for them, using either the customer's ATM card or a special purpose card. In other words, modern bank systems no longer need the traditional teller infrastructure. Bank staff are really only needed to act on behalf of those customers not able or comfortable with performing these activities themselves. Cash handling can evolve in the same way, with cash withdrawal and collection handled exclusively by ATMs. Again, bank staff may perform these operations on behalf of customers, if required. Clearly, there are dramatic possibilities for system simplification when the infrastructure is designed based on the principle that customers can directly access the core systems. In addition, more prudent loan production and customer-segment pruning may create less workload for staff, leading to smaller or fewer branches, which would reduce the cost base for the bank.

Extend channels. Bank products are somewhat limited by what kinds of purchases are considered appropriate for financing or leasing. Banks may want to challenge these perceptions to increase their business. For example, banks could explore the idea of leasing luxury watches. If you can never actually own a Patek Phillippe, why not simply rent one? It would be sufficient for the bank to insure the product against theft, and possibly ask for a collateral deposit. Similarly, what about leasing pieces of art? Can you imagine renting a Damien Hirst, with a buying option at the end of a 10-year period?

Many of these channel extensions will be for niche marketing purposes. In addition, it has to be seen how the addition of affiliate channels will impact the brand image. Nevertheless, affiliate channel marketing could be interesting as a business supplement.

Proper channel distribution remains a key element in serving customers. Multi-channel distribution is here to stay, but cost management of the total channel mix can be improved. It is generally not a good idea to abandon a channel, except in special situations. Channels need to be aware of one another and share information, as customers expect each channel to know about all previous points of contact with the institution. A large part of successfully coping with these channels is having the right systems in place.

7. Refurbish IT Systems

Many of the previously outlined ideas require flexible IT systems. Indeed, moving forward on almost any of the avenues discussed requires IT systems support. Flexible configuration, to accommodate more product features, and seamless information handling are essential elements of a modern IT structure.

Yet many institutions are trapped with legacy systems that are hard to maintain and inflexible. The challenge for banks is how to move away from this landscape, and when. The aftermath of a crisis, like we have just seen, could be the right time for a fundamental system overhaul. We believe three components are vital to revamping IT systems: architecture, performance and sequencing.

Architecture matters. In many ways, IT systems are the bank—take them away and there is very little left to work with. The basic IT architecture principles in banking include a central business partner module where all customer data and product use are managed in a central way. This master data file is essential in allowing correct handling of products, avoiding mistakes in targeted marketing, and accelerating subscriptions to new services.

In addition, the principles of service-oriented architecture are finding their way into modern

banking IT. Besides a central business partner, it is important to have a strong customer relationship management feature. Customers expect that when they contact a bank, the contact point is aware of all previous contacts, even though they may have been through different channels.

A third element relies on the security infrastructure. Opening up the bank's systems for online transaction entry also opens up the bank's systems to phishing and other attacks, often by highly skilled professionals. Banks understand today that their Internet security infrastructure must be state of the art.

Fourth, analytical reporting systems need a single warehouse that logs all financial events. As different reports may use different valuation tools for the same financial transaction, it is imperative to use at least a single consistent database as a source. This is the only way to ultimately reconcile different reporting systems: accounting, risk management, profit analysis, regulatory reporting and so forth.

Finally, it is crucial to understand that architectural considerations may make outsourcing very expensive in terms of transition costs, and even ultimately prohibitive. The benefits of a clear modular architecture are not only reflected by a better cost position, but also by better agility in terms of business process design and working with third parties that help run these processes.

Performance matters. The cost of hardware performance has fallen dramatically on a per unit basis. However, most of this cost benefit has been eroded by the ever-more-complex software infrastructure required for modern banking. Of course, the problem is not limited to banks: one has only to remember how long it took the first PCs to boot up compared to computers today. The current computer is several orders of magnitude more powerful than the old, but all that extra power is

consumed by additional features requiring more processing power and memory.

The apparently limitless supply of IT power can lead to fallacies. For instance, in the car leasing business, executives often want to lease an entire fleet of cars in one contract, as this creates a volume advantage when negotiating a deal. A fleet of cars is eligible for better insurance rates, as to some degree they are self-insuring because statistics apply to the number of cars in the fleet.

Now, in the aftermath of one of the biggest crises ever, may be the time for an IT overhaul as many competitors are licking their wounds and trying to recover.

The same is true for certain maintenance costs: in a fleet, the average car consumes 3.4 sets of tires over its life cycle, yet for an individual car one has to calculate that number as four sets. But the IT portion of processing a single contract is not as attractive. A fleet of 2,000 cars has some activity occurring with about 100 of them every day. If each of these cars is processed as a single contract item, it means opening up 100 small contracts and doing a little contract change. If there is one big master contract, the same huge contract has to be processed 200 times every day.

This requires about 2,000 times more computing power, and user response times are also 100 times slower. Ultimately, this system breaks down for very large fleets. Therefore, system design matters, and what may appear to be a solid business practice (leveraging buying power) may be impossible to operate from an IT perspective, despite Moore's law.⁴

Sequencing matters. Changing all banking systems in one go is not advisable or possibly even feasible. Banking systems management resembles urban planning: there is always some kind of construction somewhere within its boundaries. The trick is to avoid congestion in planning construction zones. The planning will be different for each bank, but some components are more central than others. Remaking a central business partner within the system would be pretty similar to remodeling High Street, as it is at the vital center of many activities; this portion is best put at the beginning of every renewal cycle. Customer relationship management systems often come second, as gaps

in customer interaction knowledge must be kept to a minimum. Financial analytics can often be less of a priority, but they should not be neglected, as regulators are likely to put more emphasis on a quality reporting infrastructure.

IT infrastructure is a vital competitive weapon. Banking is an IT-intensive business. This might seem to put the industry ahead of the curve in terms of IT, but because it was the first to fully use IT across its business systems, it has lost its "first mover" advantage, and now has the legacy problems of older infrastructure. Due to the

⁴ Moore's Law: An axiom of microprocessor development usually holding that processing power doubles about every 18 months especially relative to cost or size.

complexity of banking IT and the need for flawless testing, any change process has become very costly and even dangerous from an operational risk perspective. A modular renewal of this infrastructure would be more prudent. Now, in the aftermath of

one of the biggest crises ever, may be the time for an overhaul as many competitors are licking their wounds and trying to recover. In periods of relatively low competitive intensity, management can devote more attention to internal renewal.

Afterword

The following is an excerpt from the opening of a book on the financial crisis:

... We are now engaged in a debate over the future of the banking system at a time when our banking is, along with our economy, fundamentally weaker than at any time since the Depression... [The crisis] caught many economists by surprise because they were watching the wrong indicators...

These words come from the opening paragraphs of *Bankrupt*, by Lowell Bryan. **It talks about the savings and loan crisis of 1990.**

Indeed, history repeats itself. But just as things looked bad before, things will eventually get better. The goal is to learn from the mistakes and build better and stronger banks, and a better banking system. Hopefully, this paper provides a few ideas of how to do so.

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Appendix: The Future of Investment Banking

*Now the moon is almost hidden
The stars are beginning to hide
The fortunetelling lady
Has even taken all her things inside*

— BOB DYLAN, *Desolation Row*

With three of the top five Wall Street investment banks either bankrupt or sold in distress, and the independent future of the remaining two, Goldman Sachs and Morgan Stanley, in doubt, this industry has experienced a Chernobyl-like disaster. Is there still a future for investment banking, and if so, what type of future?

The world needs money and capital markets, and therefore people to drive these markets. At the same time, politicians and regulators will ensure that the excesses of the early 21st century will be hard to repeat. There will be financial crises in the future, but they will either have different causes or happen within the context of this tighter framework.

The common belief is that financial markets failed to self-regulate leading up the recent financial crisis. While regulations covered fair trading and other behavioral elements, they gave innovation free rein. The efficiency of the market was believed to be a bigger benefit compared to the greater safety of regulation, but this belief has proven false in certain circumstances.

Going forward, regulators will intervene in investment banking by changing some market practices and fostering transparency. Over-the-counter deals could be a thing of the past, or regulators may require online monitoring of positions. The industry abhors the mere thought of disclosing their positions, as it feels like they are showing their hand in a poker game.

Regardless, the industry does not have the credibility to argue. The challenge is now to define tighter regulation and transparency without stifling innova-

tion. To understand this, we have to anticipate the shape of future regulation, and demand for investment banking services over the next 18 months, and then examine optimal positions for investment banks to take in the current environment.

Likely Areas of Future Regulation in Investment Banking

In November 2008, the ministers of finance of the G-20 countries came together to determine a joint response to fight the consequences of the crisis. The closing statement called for new regulations, without specifying exactly what they would be. An examination of the report reveals the following is likely to happen:

Hedge funds will be regulated. Traditionally, hedge funds and banks have been considered two very separate kinds of institutions. Banks (and bank regulation) are supposed to protect depositors, while hedge funds are investment vehicles for professionals (who supposedly know what they are doing). The issue is that hedge funds borrow from banks that get their money from depositors. This, together with the fallout from the Bernard Madoff scandal, will be the fundamental cause for regulating hedge funds.

Ironically, a hedge fund is able “go short,” benefiting from a fall in prices, so ostensibly they should have been successful during the crisis. One could also wonder how to label the proprietary trading activities of banks. What is the difference between a hedge fund and a bank’s dealing room trading its own account?

A central counterparty (CCP) will be created for over-the-counter deals, making them de facto visible. Similar to benefits from the creation of CLS (continuous linked settlement), a CCP infrastructure for credit default swaps can reduce counterparty risk and eliminate clearing risk. In addition, such a CCP could be a central point for monitoring risk, eliminating excess creation of derivatives. However, one has to be careful: the creation of CLS merely led to bigger position-taking. As risk got reduced, banks did not reduce their capital, but merely took bigger

positions with the capital available.

Regulators may demand implementation of prescribed risk algorithms and online visibility of positions, in order to enable them to force a regulated participant to close positions.

Lending and dealing practices such as short selling may be curtailed and only allowed under certain conditions. Regulators already implemented a ban on short selling as an emergency measure toward the end of 2008, and the whole regulatory framework around security lending, and naked short selling in particular, could be revised.

Regulatory changes will seek to limit money-making possibilities for financial professionals, as the public and its elected representatives feel things have gotten out of hand. The financial profession should consider itself lucky that it is not being held accountable in the way that industrial companies are for environmental pollution. Although terms such as “toxic assets” are common, the principle of “who pollutes pays” has not yet been applied to financial markets. Monetary punishments would be futile, in any event, since even the most lavish bonuses are a mere fraction of the losses incurred by society as a whole during a financial crisis like the one we have just experienced.

Effectiveness of this new regulation will be highly dependent on international consensus and discipline in applying it. Even in relatively mature regulatory areas, such as anti-money laundering, some countries refuse to comply. Financial regulation, or the lack thereof, is a source of competitive differentiation between countries seeking to attract high-value employment associated with financial services. Switzerland and Luxembourg are good examples of bona fide differentiation in this area. Today’s capital markets are sufficiently mobile for investment banking activity to relocate to more attractive regulatory and fiscal environments.

Short-Term Demand

Under current market circumstances, markets are hibernating. New share and debt issuance are prohibitively expensive because of high cost, either in dilu-

tion or credit risk premium. The financial position of both the predator and prey are too volatile to try and launch major corporate takeovers. A few exceptions, such as the takeover of Wyeth, may still happen.

Over the last business cycle, investment banking struggled with its fundamental economics. With bright employees often showing a mercenary attitude, profitability was volatile. Compensation rose and a consistent cost control culture was incompatible with the prevailing “sky is the limit” attitude. In some respects, this crisis may be the perfect excuse to introduce the concept of lean investment banking, where costs are effectively controlled and compensation is related to performance, which will allow for better structural profitability.

There is a political will to fight the current financial and economic crisis by applying Keynesian methods. With Federal Reserve funds effectively available for free, monetary policy has reached the end of its efficacy. A period of large public deficits could again emerge. While countries are not immune to bankruptcy, as demonstrated by Iceland, Russia and Argentina, today’s long-term investors may prefer quality sovereign debt over corporate bonds or equity. Sovereign debt transfers wealth in a relatively risk-free way between generations: today’s pension creation is financed with future tax payments by the next generation. In this respect, it regenerates wealth lost through excessive lending and speculation.

Several trillion dollars may be spent globally to fight the economic meltdown. This means that first, long-term risk-free rates could rise, leading to improving transformation results for banks. Secondly, a few years later, governments may want to dispose of assets collected in distress, creating demand for advisory and underwriting services.

The big unknown is how interest rates will evolve from their current all-time low. To successfully fight off deflationary pressure, at some point interest rates will need to rise, short and long term, without creating inflationary pressure. This will likely be the trigger point to watch for.

Competitive Positioning along Various Lines of Business

Under this scenario, what is the future for various lines of business in investment banking?

Advisory. While mega-deal activity may be frozen for a while, the advisory business has for a long time included several boutique firms, each specialized in a particular sector or type of transaction. These firms are often led by management with considerable expertise in the chosen niche. Banks could either ally with or acquire some of these boutiques, where there is a large overlap between the bank's corporate customer base and the field of expertise of the boutique. Innovation will continue, and many start-ups will be looking for a home in these uncertain times. Areas such as specialized software, data management, medical devices, media offerings and alternative energy come to mind.

Debt origination and syndication. As investors shift their preference from high-risk debt packaged with derivatives to newly issued government bonds, the core competitive advantage for banks could well be the relationships with institutional investors, combined with a low-cost position in trading or custody. Superior and cheap order fulfillment could be the weapon to attract business from pension funds and other entities.

Syndication of new debt could well continue to thrive, as this is a risk-reducing practice. While use of exotic covenants or other packaged sweeteners may be curtailed, the principle of syndication remains a risk reducer and therefore is likely to thrive.

The possible revival of quality debt is underscored by the strong performance of corporate bond issuing in January 2009. A flight to quality, combined with strong diversification, seems to be the current trend.

Securities and money trading. Traders are unique in that they tend to thrive in both bull and bear markets. The key competitive differentiation among financial institutions will be the breadth of access to quality order flow and low-cost order fulfillment. Further automation of transaction process-

ing and fast completion of transactions in volatile markets will also be key areas of competitive advantage. Swap markets could be in distress for a while, as the future of interest rates is not clear.

Structured products and derivatives. Here, volumes could be curtailed by issuing limitations. It is unclear why notional derivative volume has to be a multiple of the underlying risk. This implies that some of these derivatives are used to net out existing positions, or a pure risk play. Both will likely be curtailed by regulators for commercial banks and market-making investment banks.

Prime brokerage. Ironically, the prime brokerage function could be enhanced in value. Originally defined as executing and managing hedge fund transaction flow, with the utmost confidentiality, it now can preserve the value proposition, but replace the confidential element with a compliance element, making it even more attractive for hedge funds, who can continue to focus on investment strategies. Use of a reputable and compliant prime brokerage house could even increase investor confidence in a particular fund.

There will be investment banking in the future. But the days of searching for excess returns by creating complex and innovative products may be over for a while, and the competitive game may center on serving customers well and in a cost-effective way. By embracing new and better regulation, and translating this into good and effective service, investment banking may be able to fulfill its essential function of managing and promoting capital markets better than before.

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