

Authors: **Andrew Stott**, Partner in Oliver Wyman's Corporate Finance and Advisory practice and **Nick Studer**, Partner in Oliver Wyman's Corporate & Institutional Banking practice

Mutation of a Species: Wholesale Banking in Domestic Universal Banks

Andrew Stott and Nick Studer, Partners in Oliver Wyman, say that in our 2007 report, "The Evolution of Financial Services¹", we applied the analogy of natural evolution to financial services and showed how certain financial services "species" had evolved over time, with some becoming extinct or mutating in response to new conditions. Since we published the report we have experienced the equivalent of a meteor falling to earth, with many species (particularly monolines of various types including mortgage providers and broker-dealers) becoming endangered and others facing the need to adapt to new market conditions. In this issue, the authors look at how recent events are likely to affect wholesale banking divisions of domestic universal banks, and how management can support their successful adaptation to the future market environment.



Market context

Wholesale banking is enduring the greatest challenge to its profitability in fifty years, and this challenge is far from over. Indeed, the aggregate loss-making performance of the last two years will continue into 2009, with 2010 revenues likely to fall below 2006 levels. Challenges to profitability have extended across nearly all product areas except FX and rates, where client and proprietary revenue opportunities have benefited from increased market volatility. Regulatory pressures will further increase the pain with risk capacity reduction coming from deleveraging in response to capital ratio sensitivities. Notwithstanding recent nationalisations, shotgun marriages, and infusions of new capital, all banks are urgently reviewing how and where to ration capital in their risk-taking activities while minimising revenue loss. As part of these reviews, we expect the economics of wholesale banking activities to come under the microscope.

Impact on domestic universals

Many domestic universal banks expanded their wholesale banking businesses significantly over the last ten years, bulking up in markets (rates, credit, and equities) and large corporate lending on the back of benign economic conditions and falling interest rates. Average returns on equity through the last cycle rose 200 basis points to around 17%. But as this rising tide starts to ebb, many banks will see the overall profitability of these activities fall dramatically, with average returns settling in a 10-15% range. Domestic universal banks will soon be forced to face reality, particularly because they lack access to, or the product range for, the biggest and most international clients. They will need to find ways to adapt to this new reality or suffer the consequences.

We have argued for several years now that most domestic universals are poorly positioned to create shareholder value in wholesale banking, especially in the large corporate segment. Their challenge has always been to offset value-destroying vanilla lending by securing revenue in higher margin, higher value-added products and services such as international trade finance, structured and asset finance, or risk management products.

¹ "The Evolution of Financial Services - Making Sense of the Past, Preparing for the Future," Oliver Wyman Financial Services White Paper (2007), available by request at: <http://www.oliverwyman.com/ow/insights.htm>.

As part of our extensive work on client- and transaction-level capital allocation, we have regularly highlighted the significant value skews in client and product profitability in the wholesale banking activities of domestic universal banks. We have encouraged our clients to focus on business models and strategies that reflect these skews. A number of banks followed this philosophy, but others behaved like retail investors before the peak of the market: they could not resist the temptation to raise corporate lending revenues even as the economy started to turn.

Challenges ahead

So what challenges face domestic universal bank CEOs as they seek to ensure a more rigorous approach to value creation in wholesale banking? First, senior executives in wholesale banking (or even the CEO him/herself) may be reluctant to give up their large, trophy clients. Moreover, in some markets it may well be that large corporates will need to lean heavily for a time on balance sheet lenders until investor markets stabilise. Secondly, governments, faced with the prospect of banks deleveraging faster than the rate at which demand for credit falls and thus exacerbating economic decline, may as a result encourage domestic banks to maintain or even increase their lending as a *quid pro quo* for government support. Thirdly, attempts to reduce revenues that may be destroying shareholder value on a fully loaded, risk-adjusted basis will be met with the usual argument that such revenue reductions cannot be matched by marginal cost reductions. But, sooner or later, domestic universals will need to make tough decisions on how to put wholesale banking activities on a sounder economic footing. Whatever else the crisis may bring, it should become easier to get broad commitment to drive through these kinds of improvements.

If management accepts the need for more radical change, what are the options? We see two broad and potentially compatible strategies for domestic universals to grow profit and shareholder value in wholesale banking: 'shrink to grow' or 'link to grow'.

Strategy 1: Shrink to grow

Under this strategy, a domestic universal bank will restructure and focus its wholesale banking activities around those segments of clients where the bank's products and services can profitably address client needs. Likely high priority client segments include middle market companies, local insurers and financial institutions, local public sector clients, and high net worth and retail investors.

Large corporate and institutional client coverage will be limited mainly to domestic clients (where the products and services of more international commercial and investment banks have less value), and to sectors such as retailing and distribution, public services, and real estate (when it recovers). Markets businesses will also need to be more selective and will draw on third party providers for more complex or international products. The domestic universal might even create or invest in a semi-independent boutique firm that provides corporate finance and advisory services (think Enskilda Securities and SEB).

Key success factors in the shrink to grow model are:

- Evaluating which revenue streams (in terms of client segments and products) are worth investing in and which should be reduced or outsourced to a third party
- Delivering sustainable cost reductions by re-engineering front-to-back processes based on the revenue stream evaluation, rather than using across the board cuts in headcount
- Reorienting performance metrics and compensation models to reward risk-adjusted performance and value created over and above the franchise value of the institution
- Managing the balance sheet and capital more effectively, including a reconfiguration of the credit distribution model
- Focusing hard on building high value bridges to other businesses such as capital markets to wealth management, corporate shareholder/management relationships to private banking (note that most group synergy initiatives we have observed are unsuccessful with many destroying value)

While this strategy focuses on a smaller revenue pool and limits growth to the domestic market, it is likely to have returns 200-400 basis points higher than a less focused approach. But success will require management discipline.

Strategy 2: Link to grow

A more controversial strategy would be for one bank to link up with another (or others) facing the same challenges, create a shared platform, and in so doing reduce costs and required capital. This linkage could be either an informal alliance or a more formal joint venture. Such a model could even be constructed as a virtual platform. The ideal context for such a platform would be the eurozone, where domestic universal banks from different countries would have a common currency and largely shared product sets,

but importantly *complementary client sets* so they would not sacrifice their client franchises. Such a platform could be developed by one of these domestic universals, or more radically, could be developed by a global universal as a utility for eurozone domestic universals to use independently of each other.

Key success factors in this linkage model are:

- Clear ownership, governance structure, and success metrics
- World class technology and operations platforms to make products available across multiple sales forces
- Clear product-supply agreements with domestic franchises (open architecture vs. last look vs. sole supplier models); clear negotiation of value-added by manufacturing vs. distribution

We anticipate that the returns under this strategy will be closer to industry averages, but with a significantly higher available profit pool and growth rates as new products penetrate a broader array of clients.

Although conceptually simple, this strategy will require excellent execution skills as well as a predisposition to collaborate with other banks, a characteristic rarely seen in this market. We therefore expect the ideal initiators of such a strategy to be a pair of banks with existing cooperative links, probably at first across two markets, thus avoiding the complications and stress of multilateral cooperation at the start of such an endeavour. Once established this platform could be easily extended to other members.

Conclusion

We expect the majority of domestic universal banks to choose the first of these options and shrink to a profitable and focused core that offers a robust, defensible profit stream. The transition will not be easy. It will demand discipline and much greater control over an appetite for risk, for compensation, and ultimately for growth than the industry has previously displayed.

Meanwhile, linking up presents the opportunity for a domestic universal to achieve benefits of scale in products and infrastructure which are otherwise not available. Only under such a model can they hope to compete selectively with the larger universals and global investment banks in the corporate and institutional client segments.

But most importantly, to thrive in the new and difficult market environment, this sub-species has to move quickly to define and execute its mutation path or risk natural selection taking its course.

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Oliver Wyman is an international management consulting firm that combines deep industry knowledge with specialised expertise in strategy, operations, risk management, organisational transformation, and leadership development.

For more information please contact Andrew Stott or Nick Studer by email at insights.emea@oliverwyman.com or by phone at +44 20 7333 8333

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