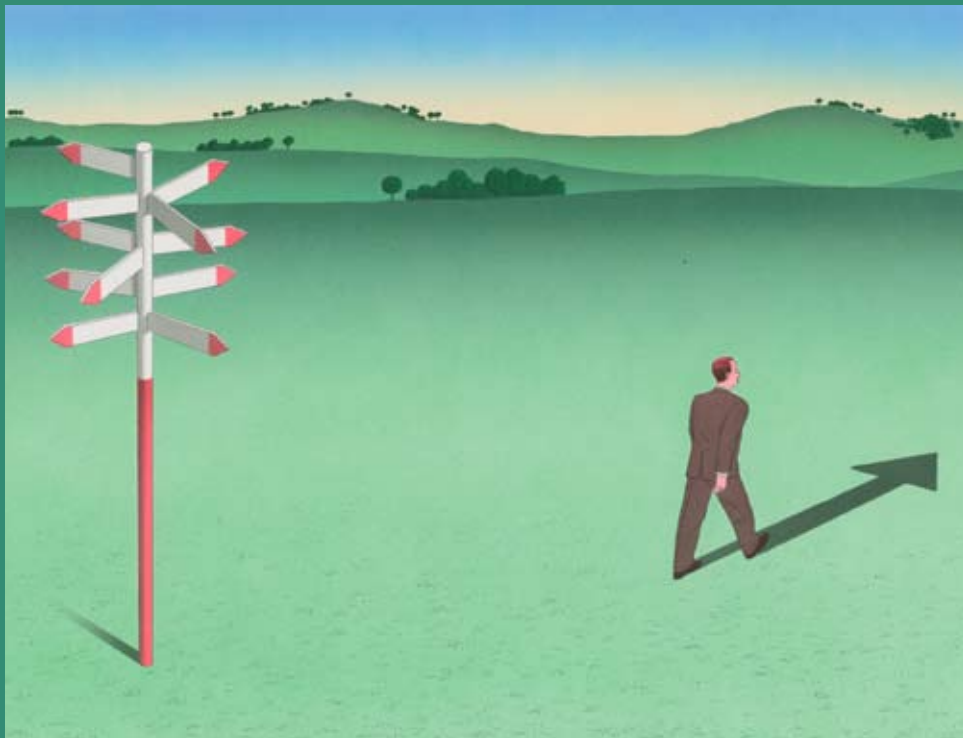


BCG

REPORT

CORPORATE BANKING 2008/2009

Thriving in the New Normal



THE BOSTON CONSULTING GROUP

The Boston Consulting Group (BCG) is a global management consulting firm and the world's leading advisor on business strategy. We partner with clients in all sectors and regions to identify their highest-value opportunities, address their most critical challenges, and transform their businesses. Our customized approach combines deep insight into the dynamics of companies and markets with close collaboration at all levels of the client organization. This ensures that our clients achieve sustainable competitive advantage, build more capable organizations, and secure lasting results. Founded in 1963, BCG is a private company with 66 offices in 38 countries. For more information, please visit www.bcg.com.

Thriving in the New Normal

CORPORATE BANKING 2008/2009

Jürgen E. Schwarz

Douglas Beal

Martin Buchar

Oliver Dany

Keith Halliday

Nicolas Harlé

Alain Le Couédic

Duncan Martin

Yasushi Motoshima

Matthew Rogozinski

Achim Schwetlick

December 2008

© The Boston Consulting Group, Inc. 2008. All rights reserved.

For information or permission to reprint, please contact BCG at:

E-mail: bcg-info@bcg.com

Fax: +1 617 850 3901, attention BCG/Permissions

Mail: BCG/Permissions

The Boston Consulting Group, Inc.

One Beacon Street

Boston, MA 02108

USA



Contents

Note to the Reader	4
Executive Summary	6
The Credit Crunch: Unprecedented Turmoil and the New Normal	9
The Turmoil	9
Changes That Are Here to Stay	10
Thriving in the New Normal: Fundamental Drivers of Competitive Advantage	12
Short-Term Defensive Moves	12
Fundamental Drivers of Value Creation	13
Drivers of Revenue	13
Drivers of Risk	21
Drivers of Cost	22
Drivers of Capital Management	23
The Path Forward	26
Appendix I: Corporate Banking Performance from 2005 Through 2007	27
Overview of Performance	27
Performance by Segment	27
Performance by Region	32
Performance Extremes	33
Appendix II: Methodology	35
For Further Reading	36



Note to the Reader

This is The Boston Consulting Group's third report on corporate banking. Recognizing that the deepening crisis has changed the rules of the game, the report focuses squarely on the strategies that will be instrumental to corporate banks as they confront the challenges of operating in a radically altered landscape.

Our definition of corporate banking covers all client segments, from microbusinesses to multinational companies, as well as all products and services that a corporate client buys from a financial institution, including loans and deposits, value-added financing, transaction services (such as payments and cash management), advisory services, and investment-banking and risk-management products. As a result, the report's findings are relevant to all financial institutions engaged in these businesses—from small players to global institutions.

The report draws on the BCG Global Corporate-Banking Benchmarking Database, which covers more than 100 financial institutions comprising more than 200 corporate-banking business units. These units serve discrete client segments such as midsize corporations. As in previous corporate-banking reports, we examine P&L and profitability performance, the drivers of revenue growth, sales force effectiveness, and cost performance. For the first time,

we have added economic capital to the more traditional measures used to compare overall performance.

For a more detailed look at performance, we divided the corporate banking business into segments on the basis of the size of their corporate clients. The micro segment covers clients with less than \$2 million in annual sales revenue; the small-cap segment covers clients with \$2 million to \$25 million in sales revenue; the mid-cap segment covers clients with more than \$25 million in sales revenue to \$250 million in sales revenue; and the large-cap segment covers clients with more than \$250 million in sales revenue.

The BCG Global Corporate-Banking Benchmarking Database covers banks from around the world. While our analysis of the database highlights trends that are shaping the global corporate-banking landscape, this report focuses mainly on the drivers of performance used by banks in the most sophisticated markets. These drivers have become even more critical for banks operating in an extremely difficult environment.

Acknowledgments

We would like to thank the financial institutions that participated in our benchmarking survey. Their contributions provided invaluable insights into the drivers of performance in the industry.

We would also like to thank our colleagues in the Financial Institutions practice for their contributions to the report—particularly Filippo Agnoli, Vassilis Antoniadis, Carsten Baumgärtner, Kilian Berz, Frans Blom, Stefan Dab, Nicholas Glenning, Gili Gordon, Alenka Grealish, Carina Hellak, Frankie Leung, Scott MacMillan, Holger Michaelis, Peter Neu, Pierre Pourquery, Ignazio Rocco, Andreas Schmidt, Benjamin Schreiber, Niclas Storz, Antony Strong, and Tjun Tang.

Finally, we would like to thank members of the editorial and production teams, including Dan Coyne, Mary DeVience, Angela DiBattista, Kim Friedman, and Janice Willett.

For Further Contact

For further information about this report or BCG's capabilities in corporate banking, please contact one of the authors:

Jürgen E. Schwarz

*Senior Partner and Managing Director
Global Head, Wholesale Banking
BCG Toronto
+1 416 955 4200
schwarz.juergen@bcg.com*

Douglas Beal

*Partner and Managing Director
BCG Dubai
+971 4 509 6700
beal.douglas@bcg.com*

Martin Buchar

*Partner and Managing Director
BCG Prague
+420 227 060 111
buchar.martin@bcg.com*

Oliver Dany

*Partner and Managing Director
BCG Frankfurt
+49 69 9 15 02 0
dany.oliver@bcg.com*

Nicolas Harlé

*Partner and Managing Director
BCG Paris
+33 1 40 17 10 10
harle.nicolas@bcg.com*

Alain Le Couédic

*Partner and Managing Director
BCG Hong Kong
+852 2506 2111
lecouedic.alain@bcg.com*

Duncan Martin

*Partner and Managing Director
BCG London
+44 207 753 5353
martin.duncan@bcg.com*

Yasushi Motoshima

*Senior Partner and Managing Director
BCG Tokyo
+81 3 5211 0300
motoshima.yasushi@bcg.com*

Matthew Rogozinski

*Partner and Managing Director
BCG Melbourne
+61 3 9656 2100
rogozinski.matthew@bcg.com*

Achim Schwetlick

*Partner and Managing Director
BCG New York
+1 212 446 2800
schwetlick.achim@bcg.com*



Executive Summary

The financial crisis has led to a striking reversal of fortune for corporate banks. The years leading up to the credit crunch were good ones for the sector, as strong economies created opportunities for growth while loan losses plummeted. Then the credit crunch began.

- ◇ By the middle of 2007, many corporate banks had become accustomed to a favorable environment characterized by steady, if unspectacular, revenue growth in their core businesses, high growth in sectors such as investment banking and leveraged finance, very low loan losses, and low funding costs. The conditions had prevailed long enough to seem like the natural state of equilibrium.
- ◇ While the positive environment allowed some players to make strong profits, for others it masked more fundamental challenges. Even during the “good years” from 2005 through 2007, for example, only about half of the participants in the BCG Global Corporate-Banking Benchmarking Database had positive and growing economic profit.

The credit crunch has had a severe impact in many markets, and the contagion effect has been rampant and devastating. The turmoil has spread across geographic markets, products, the value chain, and client segments.

- ◇ The crisis has moved well beyond its origins in the United States. The instability of wholesale funding, together with mounting writedowns, has rapidly affected corporate banks in Europe as well as in other mature markets and has now spread throughout the world.

- ◇ Since the crisis began, revenues from growth engines, such as structured finance or leveraged buyouts, have declined by more than 70 percent from peak levels. At the same time, core products were affected as funding costs rose sharply and the crisis slowed broader economic growth. Many banks have suffered rising loan losses and writedowns and face increasingly tight capital constraints.
- ◇ The instability raced along the corporate banking value chain as well. It quickly moved beyond the corporate treasury as risk teams tightened underwriting standards and sales forces were directed to stop selling loans in high-risk categories.
- ◇ As the credit crunch worsened, once-attractive clients suddenly became unprofitable. Corporate banks that could not pass higher funding costs on to their clients faced two unpalatable choices: cull unprofitable products and clients or absorb unacceptable amounts of margin compression and risk.

As a result of the turmoil, corporate banks will have to adapt to what some are calling the “new normal”—a world of slower economic growth, higher loan losses, scarce liquidity, and more realistic pricing of risk.

- ◇ As economic growth slows and business credit tightens, corporate banking clients will inevitably scale back their investments, thus curtailing their longer-term borrowing needs. And as business volumes at these companies decline, so too will their need for payment and trade products. In this tougher economic environment, corporate loan losses have already begun to rise; the severity of those losses will depend on the depth and length of the economic downturn.

- ◇ It is hard to predict how successful the wide-ranging government rescue efforts will be or when the crisis will end. Nonetheless, it is clear that the favorable conditions that prevailed in the years leading up to the crisis are unlikely to recur. There will be a new status quo.
- ◇ Corporate banks need to adapt to the new business environment. In the future, compared with the period from 2005 through 2007, capital will be scarcer, loan losses will be higher, funding costs will be more closely matched to risk and liquidity, and revenue growth will be more difficult to achieve in the face of heightened competition.

Many corporate banks have already made defensive moves in response to the crisis. For the most part, however, these have been fairly typical responses to market turbulence, rather than strategic, forward-looking adjustments made in preparation for the new normal.

- ◇ Some banks have responded by limiting discretionary spending, enforcing hiring freezes, or implementing across-the-board cuts to reduce overall costs by about 5 to 10 percent.
- ◇ Many banks have tightened underwriting standards. Banks have also restricted lending to clients such as real estate developers or have stopped lending to new customers altogether.
- ◇ The crisis has prompted some banks to embark on client turnaround plans, which typically reprice loans or reduce the number of loan-only customers.
- ◇ In more severe cases, banks have exited entire businesses such as structured finance, asset finance, or real estate financing.

To achieve strong performance in a radically altered landscape, corporate banks must focus on six fundamental drivers. Mastering these drivers will require long-term investments in people, capabilities, and systems. Within each driver, however, banks can also pursue initiatives that will have an immediate impact on profitability.

- ◇ *Value-Driven Revenue Strategies.* Corporate banks should examine both the quality and the size of their revenue

streams, giving priority to products with high margins, favorable risk-return tradeoffs, and low capital requirements. The credit crunch will create opportunities, as well as risks; for example, clients that lose access to funding sources such as commercial paper will become more dependent on banks.

- ◇ *Distribution Models and Sales Force Productivity.* As our database illustrates, banks can achieve strong performance by bringing their profitable products and sales force economics into alignment with the needs of high-potential customers. They can instill rigor and discipline in their sales processes and use sophisticated approaches to recognize the profit potential of individual customers. This would allow them to identify and prioritize profitable niches—even in mature, competitive markets.
- ◇ *Pricing Capabilities.* Strong capabilities in risk-adjusted pricing can have a significant impact on performance. These range from simple disciplines on discounting to sophisticated pricing strategies based on comprehensive data and deep customer insight.
- ◇ *Risk Management.* End-to-end risk management is a critical—albeit often overlooked—capability. The crisis has underscored the need for banks to enhance their credit-decision capabilities through a combination of better business judgment and richer data. And with many economies suffering from a downturn, banks must also improve and revitalize their monitoring and collections-management practices.
- ◇ *Cost Reduction.* Leading banks not only pursue sustained cost-reduction programs but also use them to deliver revenue-enhancing improvements. An effective credit process, for example, can free up sales resources, reduce customer attrition, and increase revenues.
- ◇ *Capital Management.* This is a long-standing but sometimes neglected core competency. Successful banks are leveraging their Basel II investments and embedding risk and capital imperatives in a range of activities such as planning, performance management, and frontline pricing. In light of the credit crunch, they are also working to transform the risk culture and the traditional relationship between the sales force and the risk organization.

To emerge from the crisis in a strong position, corporate banks will need to complement short-term initiatives with a strategy that leverages these fundamental drivers. The cost of overlooking the fundamentals of corporate banking is certain to rise.

- ◇ Middle-of-the-pack banks that fail to embrace the core drivers will eventually exhaust their quick wins. They will see their loan losses mount, their costs creep up, and their growth weaken in the face of capital constraints and more cautious risk departments.
- ◇ Top performers, meanwhile, will continue to be profitable. Their efforts to manage their client base and product mix will pay off, as will their investments in capital management, pricing, and back-office cost reduction. They will be able to overcome loan losses and lackluster revenue growth, in some cases taking advantage of the market upheaval and their clients' increased dependence on bank financing to grow their volumes and profitability.
- ◇ We are already seeing well-capitalized, high-capability banks reinforcing their dominance, and we expect to see the competitive landscape grow even more imbalanced. The superior capabilities in capital management and pricing that top performers possess—coupled with strong balance sheets—will enable them to poach profitable clients from their competitors. As a result, these players will be able to lure away highly successful sales teams, while struggling banks will need to contend with demoralized sales forces and slowly eroding client bases.