The DIBC STRATEGIST

"Dedicated to Excel

No. 39 Autumn 2009

Dear Friends

Consulting, research for two new books and training have been our priorities for the past half year. As the focus on the banking crisis moves from the 'why' and the 'what' phases into the 'how to deal with the next one', we like so many others are focusing on the lessons learned and action plans for the future.

Our book on bank strategies *(Banking in Turmoil: Sustainable strategies for the future)* was published by Palgrave/Macmillan in September, followed by several presentations to academic and banking audiences. An article in this Strategist focuses on one of the key unresolved issues stemming from our research: improving bank regulation and supervision to mitigate future banking crises.

A second book has gone to the printers updating our 2007 report on bancassurance for VRL Knowledgebank. This one focuses on the outlook for this fascinating business following the damage inflicted by the recent crisis Our views are summarized in another article in this issue.

On the consulting front, we continue to work with a major banking client on its strategic transformation. What began almost four years ago as work with a leading EU bank regulator in its

broadened into role playing of CEOs and other senior bank officials for other training clients.

Steve

Banking in Turmoil:

Strategies for Sustainable Growth

by Steven I Davis

Published

Interviews with senior bankers, regulators, management consultants, rating agencies and analysts provide an opportunity to analyze the strategies of the leading banks and to draw some conclusions on the success factors of the future

MITIGATING THE NEXT BANKING CRISIS: SOME LESSONS FROM THE LAST ONE!

Our last *Strategist* lead article ended on a dismal note: how can we avoid – or at least mitigate - the next banking crisis? Reading Charles Kindleberger's classic tome on manias and financial crises over the last few centuries should be enough to convince even the optimists that markets not only overshoot dramatically but also that the resulting banking crises are endemic to the capitalist system.

We shall not want for a plethora of suggestions on possible remedies! This has been a good crisis for academics and consultants (including ourselves) who have their ideal solution. Separating the narrow, 'ordinary' bank from the casino one, controls on bonuses, and breaking up banks that are 'too big to fail' – all make intellectual sense but are either impractical on a global scale or fail to address what to us is the core driver of the worst excesses of the past few years: **bad management!** What is that old adage – something like 'the ideal is the enemy of the good'!

But good progress has been made on agreeing on some global measures: higher and more flexible capital ratios, dusting off old liquidity guidelines from a few decades ago, and provisioning through the cycle. The world's monetary and financial managers have won kudos for proactive and massive support to economies and banking systems across the world. Now it's time to improve regulation and supervision!

Generic lessons from the crisis:

What generic lessons for the future can be drawn from the experience of the past two years?

- **bank management must ultimately take responsibility for the most egregious mistakes.** RBS's successful but disastrous bid for ABN Amro, conducted in the full view of the world's regulators and with the support of its stockholders, perhaps tops the list. UBS's lack of control over its sub-prime exposure comes a close second. Reading its consultants' report on the lessons should be required for regulators and bank management. The massive losses in real estate lending of such commercial banks as the German landesbanken, Wachovia and HBOS were largely driven by taking the easy route to growth via asset accumulation. As a matter of fact, few major banks emerge unscathed from the crisis. But leaders like Santander, HSBC, Goldman and JP Morgan took appropriate and timely action and are now today's role models.

  of the voters who have to pay the price and the media who express their anger. Breaking up large and complex banks is probably a good solution in some cases, but hardly one which can and should be applied to the global banking system. Controlling bonuses may win votes, but ultimately it is bank management who sets the bonus policy – or lack thereof. The worst losses were not incurred by bonus-fuelled dealers, and those with the biggest bonus pots, like Goldman and other investment banks, have generally had rational controls on their bonus policies. Senior bankers have been understandably reluctant to raise their heads above the parapet to present their views on the opposite side of the argument for fear of generating yet more opprobrium. Today's public debate on punishing the banks reminds one of the aftermath of the Enron disaster, ave where action taken after such anger has not necessarily added much value.

Some suggestions for future regulation and supervision

We give below some observations which might mitigate the severity of future banking crises:

Continued overleaf

- **identifying the risks arising from the crisis**
  effective regulatory action IS! In retrospect, the IMF and other multinational bodies, as well as the media, did a good job in tracking the financial crisis and its drivers. National monetary authorities have similarly taken timely and effective action in saving banks and liquefying the banking system. In the critical US market, for example, regulators insisted, against widespread scepticism, on carrying out intensive stress
  positive reaction when the results were declared was overwhelming!
- **regulators and supervisors have varied widely in terms of proactive response to the crisis.** A few, such as Bank of Spain, have earned kudos for their proactive stance on bank loss reserves and policy on SIVs, thereby preventing the excesses that have occurred in some of the other markets. While their story has not earned many headlines, the Canadian and Australian authorities have also won praise. In the realm of consumer protection, while the UK's FSA has been understandably preoccupied with its Treating Customers Fairly program, other regulators in Italy and Norway, faced with the widespread marketing of toxic 'guaranteed' complex and leveraged investment products, simply banned their sale to clients who were unlikely to understand the risks. Looking to the future, sharing of such views among regulators could well improve the overall quality of bank supervision. Merging regulators and creating new ones has generally been shown to be an exercise in frustration, but perhaps better informal communication could achieve much the same objectives.
- **one size should not fit all!** While the new global capital and liquidity standards will set minimum levels, there is no reason why they need to be applied universally across the board to individual banks or groups of banks. We recall from our own experience how the old Bank of England varied such ratios based on its overall view on a given bank's risk profile. If a national regulator like the Bank of Spain sees problems
  apply what it regards as the necessary proactive measures. Risk-takers like Goldman Sachs already acknowledge that a higher capital base is appropriate for their business strategy.
- **improve the effectiveness of supervision at the individual bank level:** Many national regulators like those in the US already position, or 'embed', teams of supervisors in major banking institutions. Such teams should have total access to risk and other potential problems and be able to communicate their concerns to their seniors. To us, their key tasks should be to evaluate management's understanding of the risks they take and to draw their own conclusions as to the resulting risks to their banking system Sadly, this process does not seem to have been very successful in the recent crisis. Our conversations in the context of our recent book on bank strategy indicate that the problem probably lies in the level of experience of the relevant supervisors and ability to communicate concerns upwards. Someone at a senior level needs to be able to take a macro view of the market, the soft spots or possible risks as a result of that view and to "require" financial institutions to act in a way which does not undermine the system, ie create systemic risk.

A typical er's
that they are best at implementing specific instructions rather than providing deep insight into risk management and other complex issues. We don't pretend to have any brilliant answers to the problem, but, apart from better training, compensation and selection policies, one solution might be to hire experienced specialists from the sector – probably on a consulting basis - who can be injected into a potential problem bank to provide expert advice. One role model for this outside the banking world this past year has been the highly successful break-up of the giant General Motors in the US and the guidance for it provided by a specialist team for the job recruited from the private equity sector. It is difficult to imagine civil servants in Washington achieving comparable success!

Steve Davis

IS BANCASSURANCE DEAD?

The lessons of the past 20 years!

Bancassurance – the sale of insurance products to a retail bank's client base – has been around for about two decades since it was born in the EU in the late 1980s.

Yet recent events appear to have struck a mortal blow to the concept. The three Benelux banks – ING, Fortis, and KBC - which in Europe created the concept of a financial conglomerate blending banking and insurance, have all suffered potentially mortal blows as a result of the 2008-9 financial crisis. Newspaper headlines continue to report the **voluntary** break-up of such bank/insurance linkages, the most recent major event being the sale of Dresdner Bank a year ago by Allianz. The notoriously inadequate profitability data on the sector does not inspire confidence in its viability. So what are the lessons of bancassurance experience over these two decades?

The short answer is that the concept is not dead, but it lives and thrives under very specific circumstances. On the other hand, for a large number of bancassurers the financial rewards are probably modest. Here are some observations from our research and client work.

- **of the various bancassurance models – totally integrated, joint venture and pure sales agreement – the first is widely agreed to be the most viable as well as profitable.** Success stories include Crédit Agricole, KBC and, more recently, HSBC in their own networks. Total integration – essentially straight-through processing with the insurance product being managed on the same basis as banking ones – not only cuts costs but should provide better service to the client and higher revenues. The joint venture approach between an independent bank and insurer, with has CNP Aviva as success stories
  proven durable as well as highly profitable compared to other distribution channels. Yet the threat of break-up always looms. The least profitable model is likely to be the pure sales agreement, especially a non-exclusive one, where the bank essentially rents its client base to an insurer for a share of the sales commission.

- **attractiveness by geographic region reflects primarily the models described above as well as relative saturation of the insurance product. s**
  Such saturation is measured by observers such as Sigma in terms of insurance premia as a percentage of GDP, with 7% a typical maximum for mature markets like the US and EU. In contrast, the booming markets such as China and India report saturation ratios of only 2%, hence the understandable wave of EU insurers active in these markets. Table 1 provides recent data on the maturity or saturation of individual developed and underdeveloped markets. On the other hand, the non-integrated business

theoretical virtues of the conglomerate model. In brief, insurance is generally sold by a highly motivated commissioned sales force, while generalist, salary-based bank employees market for banks. Bank ROEs have historically outperformed those of insurers, and the problems of managing different sales channels pose a massive managerial challenge to integrated, multi-channel firms like KBC. Among the higher profile bancassurance failures in the EU, there has been a ‘double whammy’ for groups like Crédit Suisse and Allianz, who first bought a bank or insurer, then alternated between a stand-alone and integrated model, before finally

market client base. The much more profitable SME, affluent and high net worth segments are now the target of leading bancassurers. Yet in these segments they face the competition of IFAs - independent financial advisors - with superior selling skills and client relationships. Across the globe, sales channels have evolved with growing client wealth and sophistication. The traditional insurance employee/agent channel is usually the first to appear, followed by bancassurance and then by the IFA networks. A constant threat to all channels for the future is direct channels like the Internet, which has taken a significant share of the simple, standard products such as auto and homeowners insurance. In terms of product, having perhaps initially

Table 1: Relative insurance penetration b countr pre iu s

Selected developed markets	
	ai an
	out orea
ustralia	au i rabia
ana a	olan
rance	Russia
er an	ala sia
tal	ra il
apan	out rica
pain	ina
	[redacted]
	ilippines
	n ia

Source: Sigma 2007 data

model typical of many markets such as these significantl

Changing the business model has been a massive destroyer of stockholder value. A large minority of the more than 20 bank/insurance mergers of the 1990s in Europe have since been unwound, with banks concentrating on the distribution of insurance and insurers the provision of product. Cultural and strategic factors have thus more than offset the

deciding to sell the acquired business outright at a massive loss. Most recently, the financial crisis has provided an additional incentive for divestiture by banks and insurers seeking to boost capital ratios or exit marginally profitable businesses. The latest blow, in October 2009, has been t h e E U divest itself of its massive insurance business, which has accounted for perhaps half of the group’s core earnings.

- **successful bancassurers have been both oadening offering as well as range of client segments served.** At its origins in the 1990s, bancassurance offered simple investment products to a bank’s mass

the profit contribution of bancassurance - and therefore the attention of top management - varies widely across the bancassurance spectrum. At one extreme is the US, where banks have won only 2% of the life market. When asked about the role of bancassurance in the US, one of our interviewees there reported that the sector is ‘anaemic’ in terms of financial results and therefore managerial focus. At the other extreme are EU bancassurers like Crédit Agricole, Aviva and CNP who have refined over the years the joint venture or wholly integrated model in relatively mature markets to earn a significant portion of total group profits.

And perhaps most interesting of all are a few Western bancassurers in the growth markets like Asia- o Pacific and Brazil who also have been able to export their integrated or joint venture model. HSBC, a relative latecomer to bancassurance, is one of these candidates. Within a few years, its bancassurance business has expanded to represent an impressive 1 % of total profits. We profile this case study in our report for VRL Knowledgebank.

- **banks are increasing their clout in the joint venture and sales agreement models at the expense of their insurance partners.** Our interviews indicated that perhaps 70-7 % of the total profits from such alliances accrue to the banking partner. As the provider of the alliance's client base, the bank has a powerful advantage in the dialogue over the profit split and how the alliance is managed. For example, during the recent financial crisis, differences between partners arose on the issue of product priority: banks have understandably been promoting the d
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to sell the highly profitable life insurance for which the alliance was established. The bankers' advantage has also increased as they realize the value of cross selling non-life products and ne
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interest internally.

In sum, bancassurance is not dead as a business concept. The damage to the original Benelux pioneers during the financial crisis – KBC, Fortis and ING – had little or nothing to do with the bancassurance
to do with complex financial instruments! Yet it is difficult to see many foreign competitors
in attractive markets like China and India, where the retail banking world is dominated by a few locally-owned institutions who can take their pick of foreign insurance partners and may eventually choose a large local insurer for an exclusive relationship. In the meantime, established EU bancassurers like CNP, KBC, Aviva and Crédit Agricole will continue to generate significant profits from their more integrated offerings. The threat of break-up of bank/insurance linkages, however, will continue to hang over the sector's head as M A activity forces changes in bancassurance relationships (like Generali's replacement as a Commerzbank provider as the result of Allianz' sale of Dresdner). Such changes not only may involve a considerable write-off of substantial investment in the alliance but also the internal disruption of changing suppliers. And the threat of regulatory action – as in the case of ING – may add another incentive to widen the breach between banking and insurance entities.

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