

## **Market Chaos: Key Recommendations for Weathering the Storm**

Not a day goes by without something new being written or spoken about the “credit squeeze,” imploding or frozen financial markets, or financial rescues or bailouts across the globe. Given the currency of this topic, *On Financial Services* felt compelled to add its thoughts and commentary to the fray.

### ***The Current Market Situation***

When individuals write or speak of the current financial system crisis, they refer to a range of events that have undermined confidence in the banking system. Most notable in today’s crisis is the lack of confidence in or knowledge of the value of various assets held by the banking system. Symptoms of this lack of confidence are many; to name just a few:

- Bank and investment bank failures (Washington Mutual, Lehman Brothers) or bailouts (Bear Stearns by JPMorgan Chase, Wachovia by Wells Fargo);
- The government takeover of Fannie Mae and Freddie Mac and the bailout of AIG; and,
- The end of the bulge bracket investment banks as we knew them;

These events have themselves had their own second-order effects. For example:

- Global stock markets have plunged 40% or more from their peaks; and,
- Governments here and abroad have: made direct equity investments in banking companies; extended the amount and breadth of guarantees to deposits, money market funds and even inter-bank lending; and, provided direct loans to corporations and local governments due to frozen credit markets.

By any measure, the swiftness and confluence of these events has been historic.

### **Underlying Causes of the Current Market Turmoil**

The causes for the current turmoil are varied and complex, and there is little consensus regarding root cause(s). However, any discussion of causes certainly highlights some or all of the following items:

- A housing market “bubble” characterized by easy access to low-cost funds, ATM-like home equity loans or lines of credit (HELOCs), and poor (and in some instances, fraudulent) underwriting;
- The packaging of real-estate-secured assets into complex instruments deemed by Moody’s and Standard & Poor’s to be of the highest quality and subsequently sold around the globe;
- Regulatory environments designed for the early 20<sup>th</sup>, not 21<sup>st</sup>, century that couldn’t keep up with marketplace innovation and changes;

- Unprecedented leverage ratios that helped fuel the upward momentum of financial markets and their equally rapid and violent descent; and,
- The U.S. government decision to allow Lehman Brothers to fail, helping to shut off the inter-bank lending spigot.

We mention these causes not to settle arguments or prove hypotheses, but rather to lay out some underlying drivers of the current market situation that will need to be addressed going forward.

### ***Implications of the Current Market Situation***

Although the causes and characteristics of the current situation are numerous, the critical implications are fewer:

- Financial market customers of all sizes—as well as financial industry employees—will continue to be confused, concerned and afraid. Financial services companies have work to do both externally and internally to address these fears.
- The financial services industry will retrench: capital will be scarcer and potentially more expensive, while at the same time leverage ratios decline, revenue slows and profitability comes under pressure. The industry will need to consolidate and individual players will need to bolster their balance sheets.
- Liquidity will remain a challenge for many banks, and will impinge on future growth. “Sticky” core deposits will be especially valuable.
- The regulatory landscape will change further. Regulators will become increasingly involved in all aspects of the business: regulating new institutions, taking a more critical look at areas that, in hindsight, seem inadequately regulated, and moving into new areas to regulate (e.g., executive compensation). Where regulators focus, Boards can surely be expected to follow.

### ***Recommendations for Weathering the Storm***

We believe that the current market environment and its implications dictate that financial services companies focus on three critical areas most impacted by current events: strategy development, risk management, and customer selection.

While each of these general areas is of importance at any time, we believe they are of critical importance to surviving today’s market environment.

#### **1. Strategy Development**

##### *Aligning the Strategy Development Process to New Market Conditions*

With continued uncertainty around the globe, financial services companies will need to re-evaluate their assumptions about their business and their key strategies for success. Strategic planning activities will need to incorporate much more context about how the external market situation has changed and might continue to change. This changed market situation should be incorporated into the planning process by:

- Explicitly identifying the most important and relevant marketplace changes that are related to core business activities
- Agreeing on the operating assumptions arising from these changes
- Identifying potential scenarios or sensitivities around these assumptions to make planning more dynamic (provide “what if?” thinking), to enable management to respond quickly should those scenarios come to pass

Addressing these items will encourage a more engaging, thoughtful and robust strategic planning process. The old adage, “it’s not the plan; it’s the planning” becomes more important today than ever.

### *Corporate (Portfolio) Strategy and Management*

More now than ever, financial services companies need to ensure that they are engaged in businesses where they have marketplace advantages *and* where capital earns an adequate return for the risk undertaken. Based on capital available, banks need to prioritize or rank businesses that will provide the best risk-adjusted returns going forward. They can then undertake the steps required (e.g., invest, maintain, downsize/selectively harvest, shutdown/sell) across their portfolio of businesses. Similarly, they can prioritize internal projects that support the desired business portfolio and strategies.

### *Cost Reduction Strategy*

The lack of revenue opportunities will inevitably force many companies to look to cost reduction to bolster their bottom line. Cost reduction initiatives should take a balanced perspective that includes not only financial benefits, but also operational and internal benefits. A few areas to consider include outsourcing, real estate, vendor contracts, technology, and product strategy.

## **2. Risk Management**

Recent events in the financial services industry indicate that a variety of risks need to be better monitored and managed. While numerous areas of risk need to be reviewed, two areas we want to highlight in this article are strategic risk and credit risk.

### *Strategic Risk*

Strategic risk usually relates to lost market opportunities (due to slow internal decision-making or lack of understanding external market forces that present opportunities or threats). However, strategic risk also applies to the risks incurred, knowingly or not, by making certain strategic choices (usually with poor information or insufficient understanding and analysis of the strategic choice being made). Strategic risks include, for example: entering businesses that are not sufficiently understood (e.g., AIG’s entry in to some investment banking areas); buying or selling products that are not well understood (e.g., credit default swaps and certain derivatives products); serving customers that were not well understood (e.g., sub-prime market segments); and, taking on undue leverage.

Banks need to review their key strategies and strategic initiatives and ask themselves whether they sufficiently understand the success requirements, customer segments and behaviors, required product offerings, profit drivers and overall dynamics of the business. Undertaking this strategic risk review can go hand-in-hand with undertaking the corporate (portfolio) review described earlier to make for better business decision-making and management.

### *Credit Risk*

Credit risk is perhaps the factor that most underlies the current economic crisis. No one doubts that the future portends less available credit and stricter credit criteria. Banks can prepare themselves to obtain a greater share of future "good credit" opportunities by addressing the "4 Ps of credit":

- **Policies:** credit risk management starts with understanding and making deliberate decisions on the risks that the institution is willing to incur. These risks can relate to customers, products or risk acceptance criteria.
- **Processes:** managing credit risk requires that well-defined processes are in place to ensure:
  - Adequate control over the types of loans being originated
  - Adequate checking of the underlying facts that will drive credit approval
  - Timely and complete procurement of all documentation needed to secure the loan and the underlying collateral
- **People:** judgment has always been a key part of the credit process. Banks should ensure that they have trained people who understand policies and processes and thus serve as effective first lines of defense in securing and maintaining good credits.
- **Performance measures and metrics:** banks need to have and manage to forward and backward looking performance measures related to credit

### **3. Customer Messaging & Education**

Finally, the recent upheaval in the global financial markets requires banks to rethink their existing marketing and communications strategy. Some of the questions to consider include:

- Should new marketing messages be developed?
- How should those messages fit in with the bank's brand?
- Which campaigns are still relevant? Which should be cancelled?

Campaigns that were successful only a few months ago may no longer be relevant. A number of organizations have already started deploying new marketing messages that address the changing concerns of their customer base. Citibank has gone back in time to leverage its brand from a more stable time: "Citi Never Sleeps;" ING is positioning its Orange Mortgage around "Safe and Smart".

In addition to rethinking marketing campaigns, financial services companies need to educate customers about product offerings. Given the current volatility, some target customers may be looking for stable, low-risk product offerings. Product

education can focus on, for example, educating customers about the revised FDIC insurance rules and limits.

In addition to educating customers about relevant product offerings, it may also be a good time to let customers know more about their credit scores and the factors that determine those scores. Telling customers more about these factors can assist them with gaining a better understanding of their current position and ability to obtain credit, especially in this more difficult credit environment.

The key to communicating is, first and foremost, just to do it. Banks have traditionally been "trusted advisors", certainly when it comes to "core banking" issues. Now is the time for banks to reaffirm that role: to communicate proactively and deliberately, and to tie communications to their larger brand image and market positioning.

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Financial market volatility is certain to continue in the coming months. , Given the radical changes that have taken place in the economy over the past few months, banks and other financial services companies need to exhibit a sense of urgency. At the same time, they need to fight the temptation to react to current market turmoil with emotion and without sufficient forethought. Companies that are able to focus on revamping their strategies, addressing risk management issues and updating and executing against their customer selection, communication and management goals have the greatest probability of weathering this economic storm.

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