

The Suspicion Recession: Impacts and Consequences for Financial Services Business Leaders

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The Suspicion Recession

Recession is here. But its causes and effects are different from those of the recessions of 1991 and 2002. It will be sharp, and deep, and leave some long lasting effects in the way businesses run, organise and trade. It will come to be known as the 'Suspicion Recession'.

“In times of universal deceit, telling the truth will be a revolutionary act.”

George Orwell

Against a backdrop of global doom, academics, advisors, financial analysts and even psychics are making predictions, handing out advice and pontificating the best way to beat the downturn. In this paper, we outline some provocative predictions and likely impacts.

The dominant theme for Financial Services companies in the UK, of all types and sizes, is that you will all be under suspicion, possibly for years to come. This will manifest itself in:

- Suspicious **regulators**, forced by popular demand and government intervention to move supervision away from generic principles and towards risk based policy adherence.
- Suspicious **owners**, unwilling to let executive management share in rewards or run businesses in the way they have. Portfolio investors will see little upside in Financial Services brands.
- Suspicious **partners**, worried about counterparty default, general liquidity and brand longevity.
- Suspicious **customers**, reacting against complex products and demanding transparency from providers across the board.
- Suspicious **staff**, concerned about the destruction of value in their company share price and individual pension pots, and uncertain whether their careers will follow this downward path.

Given these new realities, what are the key themes that Financial Services will see in the wider environment and within their businesses, and what response should they offer both now and in the longer term?

Key Consequences for Financial Services Firms

- Significant, new regulatory resource, structures and skills will be required. Managing the conflicting internal priorities they bring will become the key management focus for two years.
- Business Intelligence will become a more critical tool to meet regulatory requirements and provide the right information quickly for important business decisions. Early adopters applying it to specific organisational needs have a head start over those relying on 'beefing up' old BI systems.
- Resources will be focused on simple, specific products and target segments, based on formal assessment of Customer (and Regulator) needs.
- A race will start for knowledge, talent and proven processes (for example in debt and cash management). The pressure will be on organisations to have a route map to both capital stability and good credit ratings, including the people to deliver it.
- New organisational structures and processes will be developed on the back of an enhanced understanding of cost and value added.
- There will be a new breed of heroes in Financial Services and for the rest, economic stress management will be used to manage your employees.

Focus on Regulation

The regulatory environment is bound to change, both within the UK and throughout the EU and the wider world. Here we outline some overall themes and attempt to explain what a business leader will need to understand in order to overcome the consequences.

“There will be more people asking more questions and getting more information than we were getting before...there is no doubt the touch will be heavier.”

**Adair Turner
The Guardian, 17 October 2008**

- In the UK, a move will occur rapidly from principles based regulation to embedded controls. Programmes that were mothballed once SoX or ICOB were complete will re-emerge, but the focus will shift from evidence of process and audit to evidence of management accountability and formal decision trees.
- Throughout the world, regulators will introduce increased process controls focused on lending and cash management, which will require detailed modelling of liquidity scenarios. Basel II and Solvency II, or their successors, will quickly develop new teeth to bring off-balance sheet debt into view (in turn forcing governments to review PFI deals).
- Enormous changes in personnel and personality will occur within the FSA, as it seeks to attract industry talent and be seen (and heard) to put a stronger hand on the tiller.
- Publically quoted companies will be required to establish a ‘Business Risk Committee’, working alongside Nomination, Remuneration and Audit, to drive risk appetite and challenge internal risk management processes.
- Risk management and risk mitigation functions will spring up within organisations, driven from Compliance, not Finance. These will start as ferocious users of resource and management time. Compliance, audit and risk functions will compete, and create internal headaches as they vie for Board approval and resource.
- The IT implications of both new regulation and new internal compliance monitoring will drive the re-prioritisation of investment, prolonging legacy replacement issues and preventing some firms from making the key investments needed to deliver improvements to customer service.

Consequence: significant regulatory resource and new skills will be required. Managing conflicting internal priorities will become the key management focus for two years.

Focus on Business and Management Intelligence

Business and Management Intelligence will provide tangible benefits to organisations as they weather the storm and prepare for recovery. Organisations that embrace the use of Business Intelligence will enjoy greater confidence, be in a position to focus on critical activities, and meet regulatory requirements more easily. Here's how:

“In fact, most of the exciting innovation taking place today is in this boundary [between structured and unstructured data]...business intelligence is in that boundary.”

**Bill Gates
Microsoft Business Solutions
Convergence 2005, San Diego, CA**

- Increasingly evidence based regulation will require more accurate and more specific information on a more regular basis. Unwieldy MI systems will increase the risk of compliance failure. The trend will be towards the use of streamlined and heavily prioritised business intelligence data.
- Data required by new regulation will need to be shared in a transparent manner that has not been seen before. Management teams, executive Boards, internal and external audit teams and, most importantly, regulatory bodies will need to work with the same numbers. A single version of the truth will no longer be an aspiration of the Board, but a regulatory requirement.
- Business Intelligence will focus more clearly on cost and link more closely to the operational architecture. As an organisation comes under pressure to understand its minimal size and minimal cost base, having cost data available alongside performance data will become essential for fast decision making.
- Executive rewards will need to be evidenced against proven performance. Organisations will therefore be under pressure to revisit their balanced scorecard, remove the 'hobby' information and tie business intelligence directly and transparently to performance management and rewards.

Consequence: Business Intelligence will become a critical tool to meet regulatory requirements and provide the right information quickly for important business decisions. Early adopters applying it to specific organisational needs will have a head start over those relying on 'beefing up' old MI systems.

Focus on Cash (and Debt!)

Every organisation seeking to survive a downturn will need to deliver good financial management. Those seeking to do more than just survive will achieve the basics of cash management and debt collection. For this recession they will be successful in reaching and being known to have reached a sound capital position, including a good credit rating.

“The national budget must be balanced. The public debt must be reduced; the arrogance of the authorities must be moderated and controlled. Payments to foreign governments must be reduced, if the nation doesn't want to go bankrupt. People must again learn to work, instead of living on public assistance.”

Marcus Tullius Cicero

- The 2008 recession began as a credit crunch and spread to a confidence crunch in the real economy. With this in mind, shareholders will increasingly require evidence of financial stability before investing. The winners will be those who establish a 'target' financial rating now, and develop a game plan to achieving that goal.
- If credit ratings will be king, then cash will be queen. Brand name and size will not be enough to play the liquidity game this time around. It will be organisations with sharp processes, good controls and talent in their cash management, treasury and lending teams that will be able to derive value from having cash to hand when it's most needed.
- Debt management will move to centre stage as organisations seek to wipe bad debt from the books and extract all the cash they can, whilst at the same time not falling foul of TCF regulations. Once again sharp processes and talent will provide a competitive edge.
- The impact of cash and debt positions will be felt further than finance teams and the Board. Patterns of debt and cash movement will emerge that will require companies to change their business model. New products and new customer segments will be targeted as organisations diversify away from credit risks. Those able to link cash and debt analysis with product development and marketing will have an advantage.

Consequence: A race will open up for knowledge, talent and proven processes in debt and cash management. The pressure will be on organisations to have a route map to both capital stability and good credit ratings, including the people required to deliver it.

Focus on Products and Marketing

Products are likely to change for a number of reasons, including meeting the needs of Customers who are scared of credit and debt, and who will want greater guarantees relating to security and stability. So, what should product and marketing leads be expecting?

- Existing product portfolios are no longer 'fit for purpose', so financial product innovation will increase. Product managers will review their portfolios, axe some existing product developments, and undertake specific and focussed innovation of newly conceived products and services.
- Pressure from Customers and Regulators will cause FS firms to retain their simpler products, and introduce further simple products, but cull some of their more complex offerings. 'Guarantees' will have no place in the market over the coming years.
- Organisations will seek to move up their value chain, looking for extra added value and differentiation. Anything with a Unique Selling Point (USP) will be cherished; nobody will want to be in a commodity market when price wars are about to break out.
- Customer segmentation, and understanding changing customer attitudes and behaviours, will be even more important. This will mean more than just achieving customer satisfaction; every product that is not able to identify and distinguish each target segment will risk being killed off. Effective product innovations might include, for example, aiming mid-market products at high-end Customers who are down-sizing their purchases.
- Alongside focused product innovation, enlightened marketers will resist axing marketing spend, but will focus their spending on 'active' marketing (so-called 'narrow-cast' media, where customers' reactions can be monitored and valued), rather than on 'passive' marketing ('broadcast' media, where results cannot be measured).

“Innovation has nothing to do with how many R&D dollars you have... It's not about money. It's about the people you have, how you're led, and how much you get it.”

**Steve Jobs
Fortune, 9 November 1998**

Consequence: resources will be focused on simple, specific products and target segments, based on formal assessment of Customer (and Regulator) needs.

Focus on Organisation and Operations

The recession will provide a number of opportunities for dramatic Organisational and Operational change. There is a clear case for pointing at a 'burning bridge' to commit resources to undertake changes that previously fell into the 'too difficult' category.

“...change isn't emotion. Its real work and organization and strategy...that's just the truth of it. I mean, you pull people in with inspiration, but then you have to roll up your sleeves and you've got to make sacrifices and you have got to have structure.”

**Michelle Obama
CBS News, 15 February 2008**

- There will be new opportunities for the acquisition of companies and individuals (whether it goes through or not, the potential merger of Lloyds TSB and HBOS wouldn't even have been considered under 'normal' circumstances).
- Organisation structures will be made simpler as new Government-placed executives challenge non-core or 'hobby' initiatives in part-nationalised firms. This will offer the opportunity to lose non-performing ideas, functions, products and companies. Simplification will also be driven by the need for greater transparency and enhanced understanding of the business by the Board.
- Conversely, understanding an organisation's minimum critical size will be important. This is like pruning a tree: you need to do this carefully to ensure both survival and future growth. The focus will therefore be on understanding the true cost and true added value of operations and processes. Having assessed the situation, firms will redesign their organisational model to better co-ordinate the remaining core functions.
- Firms will need to make their core processes (e.g. Sales and Service) leaner: to achieve necessary efficiency improvements, to meet new monitoring requirements, and to support new products. This will particularly apply to Sales (including Lending) and Service processes, which will need to be more transparent and more easily audited, whilst not being over-burdened by 'tick box' compliance requirements.
- The relationship with the Customer becomes even more important where trustworthiness and transparency are critical. Understanding the 'Customer Journey' (sometimes called the 'Voice of the Customer') and the 'two feet of space in front of the Salesperson' will become truly important, and will drive the need to engender the right attitude and behaviour on the part of the sales force.
- Lean will be accepted as the prime mechanism to ensure all activities are essential (customer or compliance focussed). Pure Six Sigma is less useful for sensible cost reduction and will lose favour in the financial sector. Lean will be adopted as the ongoing method for achieving continuous improvement.

Consequence: new organisational structures and processes will be developed on the back of an enhanced understanding of cost and value added.

Focus on People

Just as recession will increase the justifications for change made by customers and regulators, so too will staff become nervous and suspicious of changes occurring within their organisations. Those organisations that cut staff costs dramatically for short term survival could pay the price in the long term.

- Human Capital Management will become more important. Not only will peoples value to a company need to be understood more (in order to keep the right people), but those that are kept will need to be managed more skilfully. High insecurity, low levels of trust, morale impacted by the economy, and employee sickness rates will all need to be managed by skilled line managers.
- Whilst older staff will be worried about pension pots with more people looking to stay in work for longer, younger staff are likely to 'get their heads down' and just get on with their work. There is likely to be a severe risk aversion with fewer people willing to raise their heads above the parapet. This will reduce human innovation and ideas generation at a time when invention and differentiation is likely to have the greatest benefit.
- Performance management becomes easier as people work harder in the short term as the threat of redundancy looms, staying the extra hour and wanting to prove their worth to the organisation. On the flipside, bonuses will be cut in a bid to preserve cash. Whilst employees are likely to have some understanding of bonus cuts in the current climate, 'cranking the handle' is unsustainable in the long term.
- It is likely that there will be a new breed of 'hero' within financial services organisations with the rising prominence of such roles as auditing, compliance, risk management: corporate 'gags' may be placed on 'pushy' sales people. Some role reversal is going to be seen within organisations.
- Insurance companies will begin to be hit with multiple Directors and Officers claims, and this class of insurance will become increasingly difficult to buy and finance. The opening up of individual liability will drive a shift in entrepreneurial talent away from large businesses and towards start-ups. Personal liability for all staff handling financial decisions is likely to increase.
- Ultimately, recession involves a fundamental fear of the future. Employees will bring their economic stress to the workplace and leadership will have to address these concerns if they are to keep their staff motivated and working effectively.
- Clever companies will take the opportunity to grow their talent pool by acquiring new skills and using new blood to address low motivation. They will also reduce, but not crucify, their training budgets and use these for more strategic training decisions.

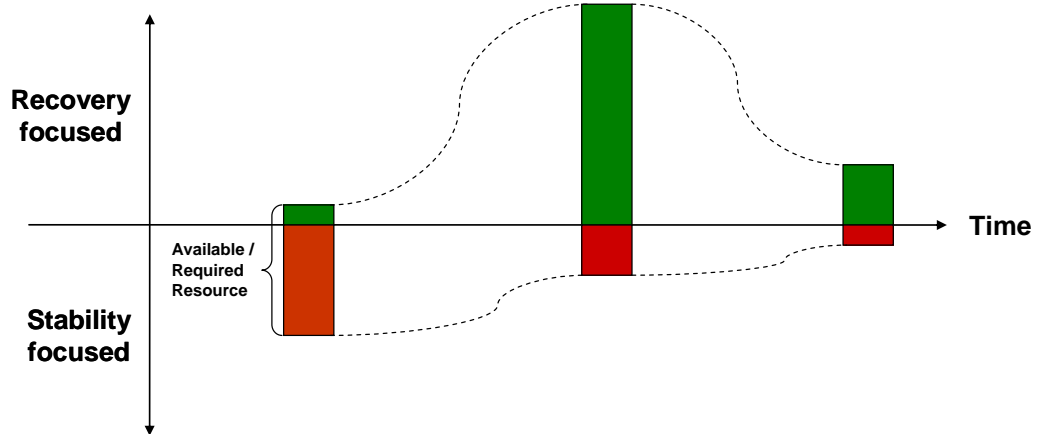
"It's a recession when your neighbor loses his job; it's a depression when you lose yours."

Harry S. Truman
Observer, 13 April 1958

Consequence: there will be a new breed of heroes in financial services and, for the rest, economic stress management will be the way to manage your employees.

Hitachi Consulting's Response

The 'credit crunch' and its recessionary consequences represent the greatest challenge many business leaders have faced in their careers, as they are entrusted with navigating their businesses successfully through a severe economic downturn. They are faced with the impact of recession on their sales, profits, cash flow and, operating in the financial services sector, also their character.

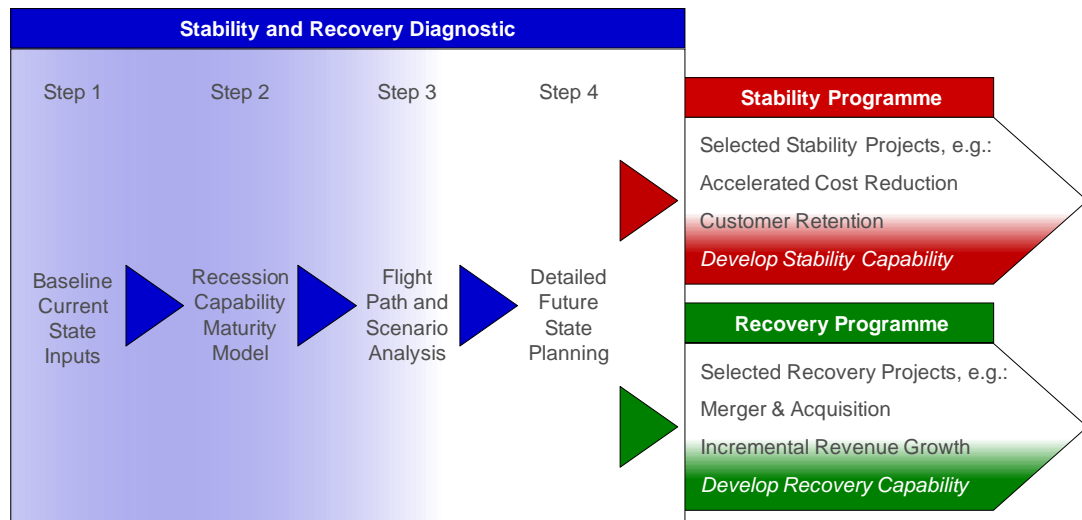


There is no 'silver bullet' or direct lessons from the past, but there are important cues from previous recessions. Chief amongst them is the certainty that those companies who focus solely on 'fire-fighting' activity will lose customers, revenue and their best staff over the longer term. Whilst stability and cost protection measures are being put in place, effective leaders will not lose sight of the strategic opportunities that turmoil brings to change and renew business models.

Making and executing strategy during such times requires fast footwork and a rapid reassessment of the way circumstances change with each major event. Responsible Executives need to determine whether to take an offensive or defensive approach, to decide on the relative importance of reducing costs, increasing investments, creating financial flexibility, and seeking near-term revenue growth.

Hitachi Consulting has used its experience of past recessions in conducting accelerated cost reduction, and history of product innovation and business model incubation, to develop an action orientated programme, specific to Financial Services, to ensure your business will both survive the near term challenges and thrive on the long term opportunities.

The Suspicion Recession



This programme, named 'Stability and Recovery', will create:

- A balanced view of where to deploy limited resources for maximum effect
- Comprehensive knowledge of where your biggest risks lie, and what to do about them
- Practical advice and implementation support on where costs can be removed quickly, but intelligently
- Insight on how to respond to the changing behaviours of customers, suppliers and regulators
- A plan for how, where and when to invest precious cash in 'era defining' business opportunities
- Support in managing a portfolio of initiatives in a time of great complexity and uncertainty.

As part of the part the 23rd largest company in the world, that has been successful in continually evolved its offerings over the last 100 years, we understand how to weather difficult times and how to exploit them

This Programme, and the internal outcomes that will be driven as a result, will allow your organisation to regain the trust of regulators, owners, staff and customers, and deliver a platform for sustained success over the coming years.

For a discussion on the points of view expressed in this document, the approach to our Stability and Recovery Programme, or to understand the specific items in more detail, please contact any of the authors.

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About Hitachi Consulting Corporation

As Hitachi, Ltd.'s (NYSE: HIT) global consulting company, with operations in the United States, Europe and Asia, Hitachi Consulting is a recognised leader in delivering proven business and IT strategies and solutions to Global 2000 companies across many industries. With a balanced view of strategy, people, process and technology, we work with companies to understand their unique business needs, and to develop and implement practical business strategies and technology solutions. From business strategy development through application deployment, our consultants are committed to helping clients quickly realise measurable business value and achieve sustainable ROI.

Hitachi Consulting's client base includes 25 percent of the Global 100 as well as many leading mid-market companies. We offer a client-focused, collaborative approach and transfer knowledge throughout each engagement.

For more information, call +44 (0)870 850 6669 or visit www.hitachiconsulting.co.uk.

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