ESMT No. BB-110-001

ESMT
BUSINESS
BRIEF

European Banks:
The Way Forward Toward Resilient Business Models

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ISSN 1866-4024

Citation:

Felix Stephan Fremerey and Jan U. Hagen; **European Banks: The Way Forward Toward Resilient Business Models;** Business Brief No. BB–110–001; ESMT European School of Management and Technology, 2010.

Contents

Executive summary

The ongoing world financial crisis, now in phase two mainly affecting the loan books of banks, is forcing financial institutions to reflect or modify their business models. A review of the last full credit cycle shows opportunities to identify the relevant drivers of value that are measured in terms of both return on equity and risk. On this basis we analyzed the balance sheets and P&L accounts of about 65 European banking groups over the last cycle (2000 to 1H 2008).

Five drivers define the long-term success of a bank's business model: the dynamics of growth, the asset mix, the size, the cost-to-income ratio and the relative market share compared to the banks top three country peers. The biggest change is made up by differences in growth dynamics and the asset mix and not by costs, market share or size, as conventional wisdom might tell us. As most practitioners in banking might have experienced for themselves, sheer cost management does not pay of in the long run, nor does size. Big is not beautiful, but growth dynamics are, ideally combined with a growing relative share of the bank's genuine customer business.

As we show in detail, based on these five drivers managers are able to define their management agenda inside a consistent empirical framework. The key to success in defining a strategy is to knowing one's relative position within the competitive risk-return arena. This arena not only includes listed banks but also state-owned institutions and cooperative banks of relevant market share as well.

The results of the survey are fully justified by the developments we have seen in the financial year 2009.

1. Business models in banking: Definitions and key questions

1.1 Research subject "business model"

There continues to be heated debate about the nature and causes of the world financial crisis. Governments bailed out banks through protection schemes. At the same time they tried to stabilize the economic downturn in the manufacturing industries and in world trade. Ratings agencies adopted rating models to reflect new realities and downgraded banks. Even sovereign debt is on the watch-list. Top bankers are invited to meetings on bailouts or summoned to congressional hearings. They try to find ways to settle their balance sheets and to raise their core capital quotas. Politicians and even bankers themselves have asked for new business models, especially risk-adjusted and resilient ones. Even stricter regulations appear to be tolerable. Nobody wants to see a crisis like the one caused by the collapse of Lehman Brothers ever again.

From what we have seen in recent years while reviewing annual reports and investor relations' releases, clear definitions of banks' "business models" were often missing. An outline on the "resilience" of the results achieved (and planned) was almost always excluded. Somewhat vague terms like "commercial banks," "investment banks," "private banks" and "wholesale banks" were generally accepted. The terminology from the past has lost most of its meaning.

We propose to define business models alongside the mix of assets managed by a bank or a banking group. This allows for a straightforward and unbiased view on what is really in the "business model" and what is not. A commercial bank, for example, nowadays might end up with a balance sheet containing 70% capital market assets without being properly recognized for its de facto position as a wholesale or investment banking institution.

Based on our analysis, a "business model" and a solid strategy definition must provide simple answers to three questions:

- Does the bank invest "directly" in customer-driven business or "indirectly" through investment in capital market assets?
- How does the bank organize growth? Does the focus lie on organic growth or on M&A; on national consolidation or international expansion? Does size matter or is a strong niche position targeted?
- How should the long-term cost management look (measured by cost-to-income ratio)?

In the context of our survey, we will define "resilience" as the ability of a bank to achieve a long-term pre-tax return on equity (LTROE) of at least 8%. The Capital Asset Pricing Model (CAPM) currently implies the opportunity costs of equity (COE) for a bank to be at 12% pre tax return on equity. However, as investors are able to invest in other forms of assets such as bonds, cash and real estate, we assume a lower rate to be a relevant "hurdle." We acknowledge, however, that an 8% pre tax return will not always be sufficient to attract equity investors on the stock market. The LTROE is only one component to "resilience"; the other one is the risk related to volatility attached to the strategy and business mix.

The key decisions as outlined above could be defined long- to medium term; they are not a question of day-to-day business. The latter cannot hinder top managers in further developing and adopting their business models. This holds true especially for banks in M&A situations or turnarounds.

Methodology

For this survey we reviewed the P&L accounts and balance sheets of 65 European banks and banking groups. The focus was put on long-term effects of different business models and strategies on long-term profitability. Our approach was driven by the question "What makes long-term success likely?" and not "Have we chosen the relevant peer group?" or "Are we different because we operate in different countries or regulatory frameworks?" For those who like to claim that long-term averages of return on equity (LROE) do not reflect future opportunities correctly, we attached a country-specific outlook section to the end of our survey (see chapter 6).

For each institution, we analyzed the data from the annual reports for the period between 2000 and June 30, 2008. In very few exceptions, the timeline was shorter due to M&A activities or availability of data. Financial conglomerates were split into banking and insurance, if applicable (ING, DZ BANK). Banking groups with a large number of individual regional banks (mainly cooperative banks) were grouped in a way that the size of each bank was computed as an average of the whole sample (Italy, Germany).

The charts were designed in a way that is in line with reporting in the extensive Profit Impact of Market Strategy program, launched in the late 1960s. This provides readers with a condensed analysis format for interpretations. The LTROE and volatility values, for example, are all long-term averages covering one full credit cycle. All banks were clustered into quintiles of 13 banks each. In order to “ease” the effect of double averaging, we show key results, including their extreme values. Please note that a value of 9% LTROE in a bar with a minimum of 7%, a maximum of 15% and an average of 10% reads as: “Bank X achieved an average LTROE of 9% pre tax while the other 12 banks with similar business characteristics achieved on average 10%, with the best bank in the cluster achieving 15% and the worst 7%.”

Overall, our database uses more that 15,000 single data points, most of which are directly drawn form the annual reports. It is important to understand that no adjustments were made to stated figures to assure at least a minimum of data consistency. Extraordinary or one-time restructuring effects all impact the bottom line, but not the taxes paid. The base assumption here was to rely on the long timeline of the analysis and on the representative characters of the banks selected

1.2 Key questions

Based on this methodology, the authors would like to discuss the following aspects:

- What are the relevant options for banks to grow in a profitable way in the future? How can new share capital be raised successfully on lower expected rates of profitability?
- What should an M&A agenda look like?
- Are there any top management figures at hand for investors who could provide information other than what has been discussed by ratings agencies and analysts?

- Will bank managers have broader or more restricted competences for developing the business models of their institutions? Will strategies differ from the ones that led banks into the actual crisis?

2.
The first strategic imperative: “Growth dynamics”

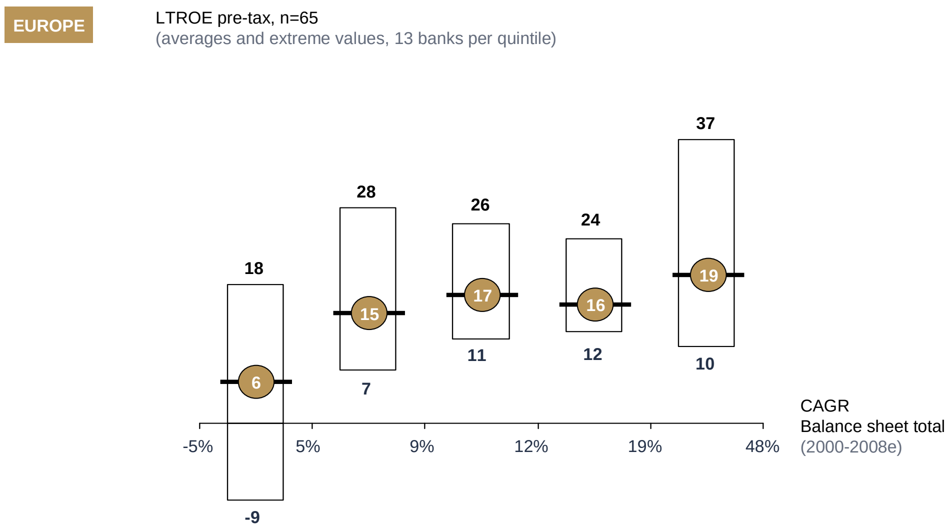
According to conventional thinking, growing balance sheet totals and growing risk weighted assets (RWA) lead to higher ROE, mainly due to a higher net banking income (NBI). Of the 65 banks covered in our survey, only a few were able to grow their NBI in line with the total balance sheet growth, implying stable gross margins. The Austrian institutions RZB, BA/CA and ERSTE were able to leverage a one-off situation in the CEE market to realize outperformance in NBI; all others grew at rates that were in line with or lower than their balance sheet totals growth.

Empirical stable results were achieved by banking groups that demonstrated growth combined with an efficient management of their cost positions. A prerequisite for this strategy is to select a growth path that is based on already existing competencies and that avoid complexity. Banks that entered too many markets or introduced too many new product areas were not able to profit from their respective growth initiatives in the long run.

As one can see in Chart 1, it seems to be a straightforward conclusion that growth dynamics lead to higher LTROE. The increase in LTROE decreases with increased growth rates, implying that high-growth strategies in banking have certain limits.

Chart 1: Annual growth rate of balance sheet total in relation to LTROE

An asset growth momentum of at least 5% per year will increase the likelihood of higher LTROE significantly



Out of the 80% of banks with growth rates higher than 5% per year, none achieved an LTROE of less than 7%, with averages realized between 15% and 19% in the top four quintiles. Given that growth rates between 5% and 9% are close to the underlying economic growth rates in low-interest-rate scenarios, we assume that in the sample of growth banks, both organic strategies and M&A-based growth are included, often a combination of both.

It is worthwhile to note that the 13 banks in the bottom quintile all are located in the German-speaking parts of Europe, that is, Germany, Switzerland and Austria. At the same time, the top quintile stem from 10 different countries, including the United Kingdom, Austria and Italy (two each), as well as Hungary, Germany, Norway, Greece, and France.

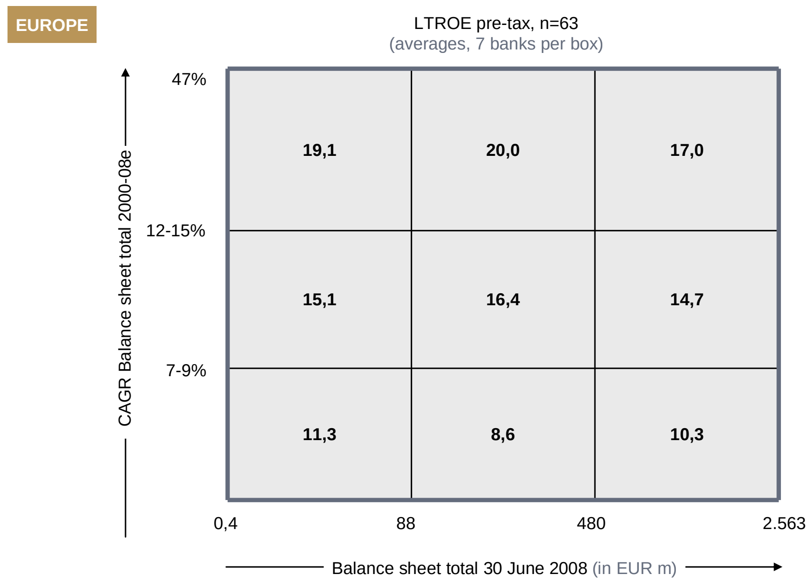
Long-term analysis is only applicable long-term. The growth imperative, implemented short-term and without preparation, could lead to the exact opposite effect of the intend one. Empires were not built in a day; the resilient ones were created over decades. We have observed that some competitors—especially ones from small countries like Portugal, Belgium, Ireland and Austria—have “overpaced” growth and M&A in recent history. However, this does not change the general assessment that a solid growth path should include organic and inorganic elements.

Even in the decade of "shareholder value," successful growth was not a function of the ownership structure. In the top notch of high-growth banks, we see listed banks (RBS, UniCredit) as well as cooperative ones (Credit Mutuel, RZB, Volksbanken AG). In the smaller banks bracket, there are even some banks with strong private family investors behind them.

Growth dynamics and sheer size were often mixed up. This does not match our data sample, where one can see that growth dynamics are a strong indicator of high LTROE, whereas size is not (Chart 2). High growth rates, by definition, lead to sizable balance sheets; however, it is the dynamics that make the most difference. We discuss size in chapter 4 in more detail.

Chart 2: LTROE averages of banking clusters, depending on absolute size and growth dynamics in the last full credit cycle

A stronger growth dynamics leads to higher LTROE independent from the size of the bank



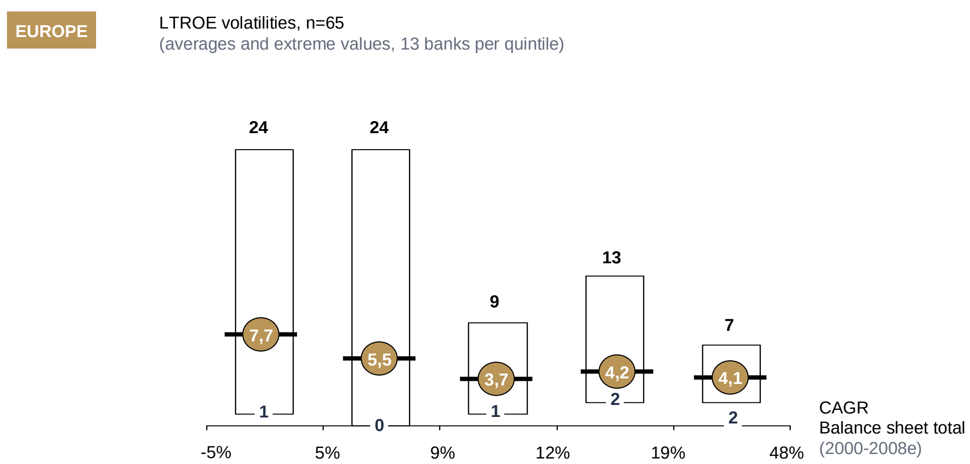
Looking a little more closely at the details of Chart 2, we see that "small banks" by European standards (up to a balance sheet total of EUR 88 m) achieved reasonable LTROE figures when they were able to reach an annual growth target of at least 7% to 9%. The LTROE difference is on average 4 percentage points (PP) and in the high growth segment close to 8 PP, compared to the non-dynamic peer group at the bottom.

Significant underperformance can be observed in the quadrant of mid-sized banks without growth dynamics. LTROE of 8.6% is a poor performance that results from a combination of two effects: there is almost no room for higher efficiency and economies of scale while at the same time there is no critical mass for being a relevant top player in a global or even in a European context. A way out of this dilemma could lie in strategies for stronger customer care and customer penetration or in vertical integration schemes for banks that are "embedded" into larger financial groups (such as savings banks and cooperative banks). If vertical integration is not intended, horizontal and international cooperation could ease the situation as well.

It is fair to evaluate the potential return on equity, but the picture becomes complete only when looking at the risk dimension of growth as well. Chart 3 demonstrates that the volatility of LTROE decreases with growth dynamics.

Chart 3: Average ROE volatility per year compared to LTROE, depending on different growth clusters with extreme values per cluster

An asset growth momentum of at least 9% per year lowers the volatility of the LTROE substantially



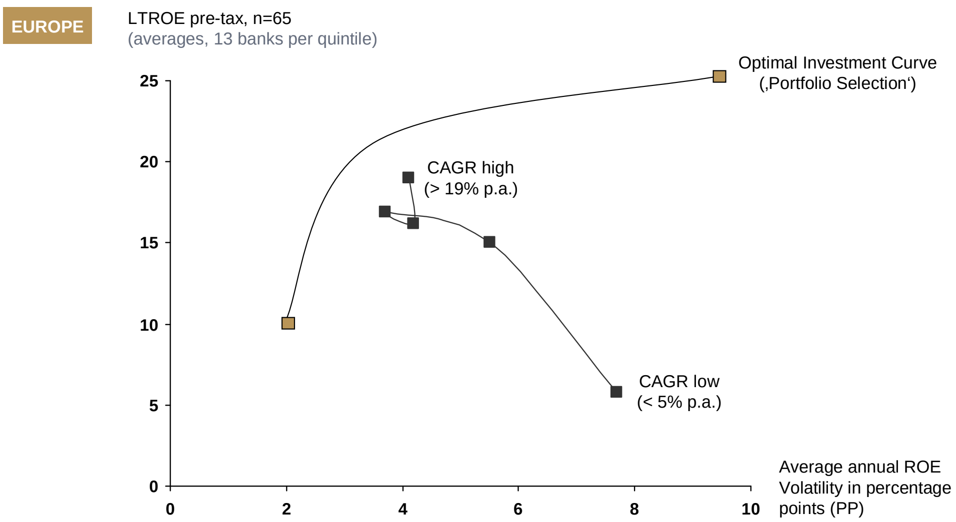
The 26 banks with a compound annual growth rate (CAGR) below 9% are quite volatile, with average annual volatility of 5.5 PP to 7.7 PP. This leads to negative judgments by ratings agencies and makes proper strategic planning in most of these institutions a random exercise. We have to admit, though, that at least two banks in the no-growth to low-growth bracket demonstrated very low levels of volatility: Rabobank and Raiffeisen Switzerland.

Different results were achieved by the group of moderate- to high-growth banks, where the average volatility lies between 3.7 PP and 4.2 PP. Most striking here is that the extreme values realized by these institutions are more in line with the average, making estimates easier and banks more resilient. The 65 banks in our survey had a CAGR of 11% in the last credit cycle, while we saw an average growth of 9% among all European banks in the period.

If we now plot the results of charts 1 and 3 in a combined portfolio graph (Chart 4), we see a clear relationship between resilience and growth: in the absence of growth, no matter if it is organic or not, most institutions fail to create stable LTROE. The old management wisdom of “grow or go” still has a strong underlying logic. Based on this long-term “imperative,” we would recommend that all banks without growth history reflect on their strategies in order to improve their long-term results. We do not, however, state that no-growth always fails, but looking back to the last credit cycle, it seems clear that this would be the more difficult way.

Chart 4: LTROE depending on different growth clusters in Markowitz portfolio view (combination of charts 1 and 3)

Over the full credit cycle growth momentum leads towards optimization due to higher LTROE combined with lower risks levels



In order to cross-check these quite fundamental conclusions, we isolated the banks in the Eurozone coming to exactly the same pattern. This even remains evident when looking at banks only in the German-speaking countries.

From the five drivers in our empirical focus, there is one other with comparably puzzling results. We discuss this in the next chapter.

3.
The second strategic imperative: "A customer-centric balance sheet mix"

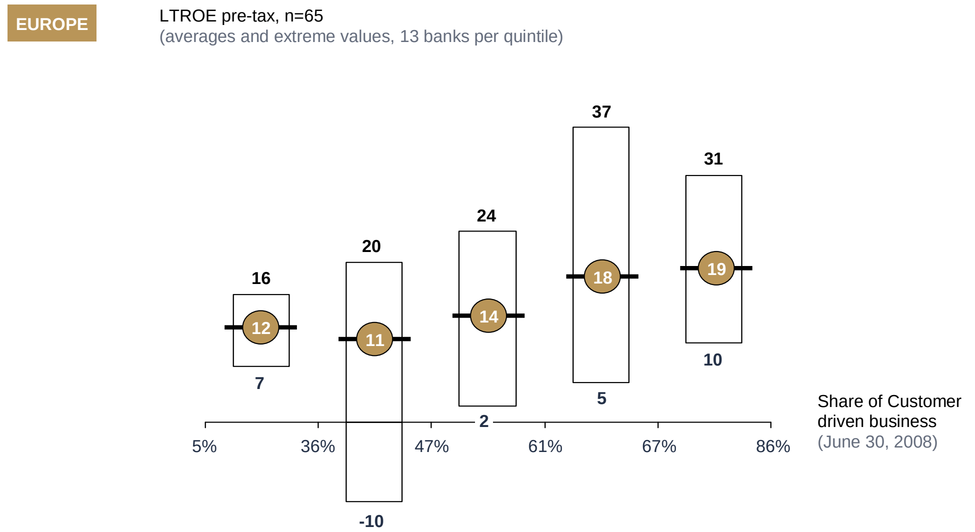
Outside the banking industry cooperation of companies in R&D, procurement and other key areas are common phenomena. A seldom and sometimes completely unknown phenomenon is the one in which competitors credit their peers in order to compete in the same markets and for the same customers. This is exactly what a number of banks did by buying structured credit products from competitors active in their own markets. As we will see below, it is different if you own a true credit asset or just a security backed by assets (ABS).

As per June 30, 2008, some 50% of all European banking assets consisted of loans advanced to customers, excluding banks. The loan proportion in the asset mix of individual banks is quite diverse, ranging from a mere 5% of total assets up to 86%, depending on their business models. We excluded loans advanced to banks and financial institutions from "customer business" based on the assumption that these assets are used to refinance other, but not the own customers. Following this logic, debt securities, equities, financial investments and other assets belong as well in the "wholesale business" part of the asset mix.

In the aftermath of the Lehman insolvency, we received strong evidence of how necessary open credit facilities among banks are for the stability of the banking system. However, lending savings to other banks can hardly be considered as "customer-driven business," except for the central banks function of savings and cooperative banks.

Chart 5: LTROE depending on relative share of "customer-driven business" (quintile averages with extreme values)

'Customer focus' pays of in terms of higher LTROE over the cycle



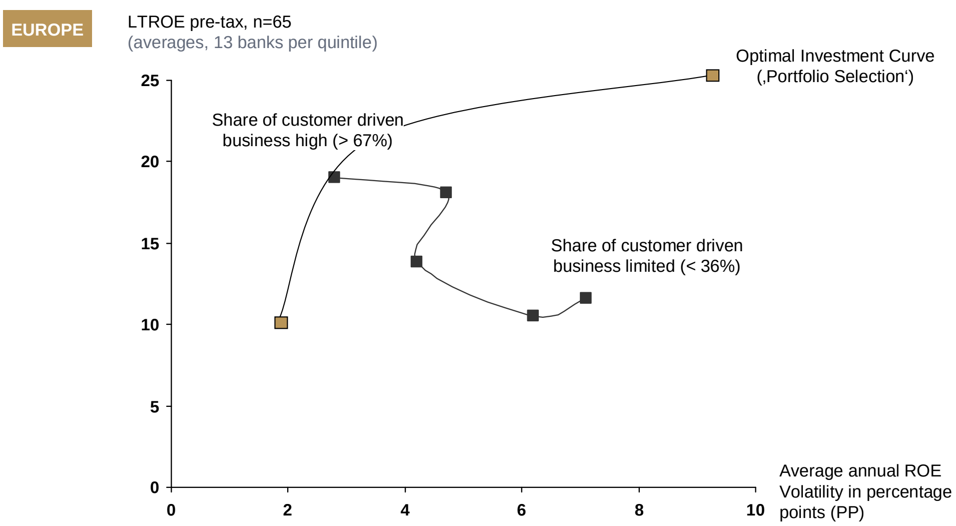
We discussed already that the NBI of the banks did not grow in proportion when compared to the balance sheet totals over the cycle. One could take this as proof for the maturity of the European banking markets (with the sole exception of the CEE region). But this should not lead to the often drawn conclusion that new business with customers is going to be unattractive. In the top quintile of banks in Chart 5, we observed only two banks from CEE and two from Greece, while the nine remaining banks run their businesses in mature markets such as Spain or Switzerland.

Please note that—in contrast to NBI—the LTROE is computed after taking all credit-risk-related costs into the equation (loan-loss provisions and write-offs). In order to make a fair statement on the customer-driven business, it seems worthwhile to look over a full credit cycle that includes one depression period. In day-to-day investor relations presentation practice, one seldom finds a time-series longer than three, maybe five years. Credit cycles almost always receive no reflection in mid-term-planning, except for ones that have started already.

In standard university classrooms, students are taught the basics of portfolio management and how to interpret portfolios according to the Markowitz model. We therefore assume a widespread knowledge of the fundamental drivers of risk and return. In the asset management industry, working with Markowitz portfolios is already part of the daily routine. In management presentations, however, focus still lies on expected returns on equity for shareholders, whereas corresponding interpretation of risk is still a rare exception. Banks with low LTROE could be a reasonable investment for investors (or customers) if the volatility is accordingly low. We would like to showcase Rabobank here, which, by the way, is the only bank in our survey that still enjoys an AAA rating from all ratings agencies.

Chart 6: LTROE depending on different relative share of customer-driven business in Markowitz portfolio view

A stronger focus on ‚conservative', customer driven businesses paid of in terms of LTROE and risk limitation, at least for European banks



A distinction between "stable" and "volatile" banking business is well established. In most cases this reads as "stable equals low returns" while "volatile equals high returns." Chart 6 shows us a different reality. The higher the proportion of customer-driven business is in the long run, the higher the chances to achieve higher LTROE at lower levels of risk. Some continental European banks might readjust their business models on this basis, whereas some are already "on their way."

For certain reasons, we excluded the main effects of the world financial crisis here. Including the year-end figures for 2008 would have overstretched the curve in Chart 6 to the bottom-right, making the effects even more evident. Even if we had selected a different time period, for example 2000–2005 or 2002–2007, the curve would not have changed dramatically. The entrance or re-entrance of classic commercial banks in Europe into investment banking did not pay off for any of the banks in our sample. As we know today, even out of five leading Wall Street investment banks, only two have survived the cycle and the crisis so far.

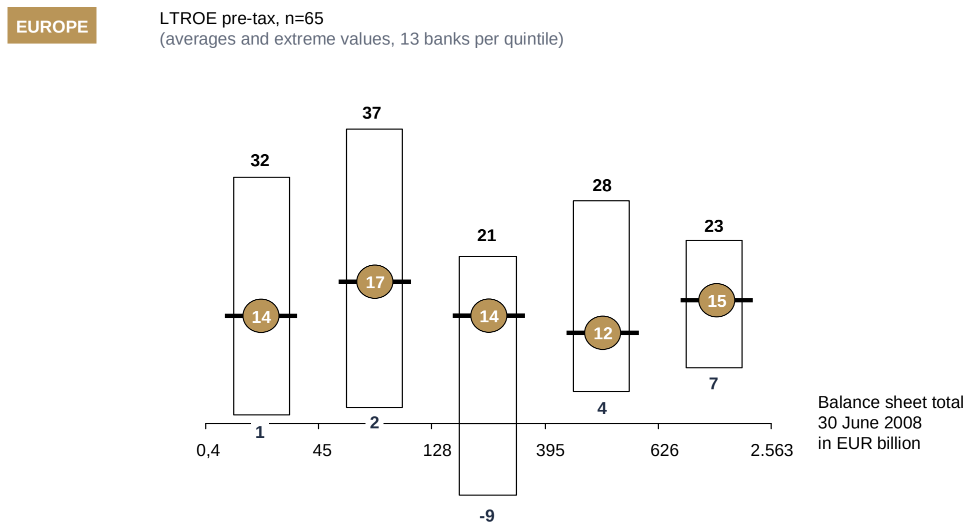
4. Important indicators, somewhat overemphasized: Size, cost discipline and relative market share

In our survey, small- and medium-sized banks with balance sheet totals up to EUR 130 billion performed in line with overall averages. Specialized institutions such as private banks or real estate specialists turned out to be reasonable investments, too. European blue chip banks, members of the EuroStoxx 50 or Stoxx 50 like Santander, HSBC or BNP Paribas demonstrated outperforming LTROE rates due to their “premium” rank in terms of size and reputation. In the sizeable banks bracket, traditional arguments of economies of scale still seem to prove themselves out, as one can see in Chart 7.

But compared to the findings in the two previous chapters, one could hardly say that size and LTROE are systematically correlated.

Chart 7: LTROE in relation to balance sheet totals as of June 30, 2009 (averages with extreme values)

Size does not correlate systematically with LTROE, some positive diversification effects could be seen in the top quintile



However, it is worth taking a more detailed look at Chart 7. Intermediate-sized banks in the two quintiles between EUR 128 billion and EUR 626 billion of total assets (such as Dexia, KBC, Commerzbank, SEB or Natixis) grew naturally from their regional importance. Their respective franchises and customer bases hardly allow them to run broad-scale operations around the world that span the globe. All this translates into problems to generate stable LTROE, although on average the picture here still looks quite balanced.

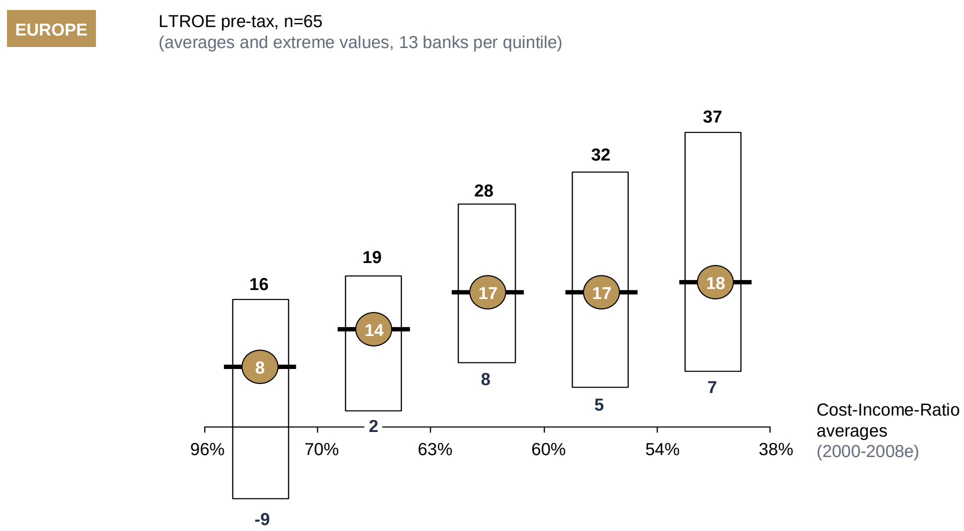
The world financial crisis hit these medium-sized banks harder than any other group in our sample. The way out most likely lies in applying "up-or-out" kinds of strategies, as tried by Fortis without success or by Dresdner Bank, which ended up as a junior partner to archrival Commerzbank. We observe now what could already have been concluded earlier: the mid-sized banks are retreating into their well-established businesses, some of them forced by the European Commission. One consequence will be a stronger customer orientation, not necessarily with lower LTROE. At any rate, the rift between local banks on the one hand and a small number of true multinational players will likely grow.

Some of the favorite measures of bank managers to demonstrate efficiency by senior management are cost-cutting programs, outsourcing of projects and all sorts of short-term measures. Few areas offer better opportunities to create so-called "quick wins," regardless of whether they turn out to be "medium- to long-term losses." Results are easy to observe and to quantify. There are no customers that need to be asked, no products to be developed, no uncertain risks to be taken (at least not in the short run). Except for the usual trouble with labor unions, cost management programs appear to be something that bank managers and investors like to implement and buy into. Effectively presented to analysts, cost-cutting is still considered to be one of the best short-term remedies for staggering stock performance. But does all this truly makes a difference in achieving LTROE?

Chart 8 shows the importance of managing the cost position. The numbers show as well the limits of cost management, because when compared to competitors, almost no difference could be seen after a certain threshold has been reached. We assume the "critical" cost-to-income ratio for most banks to be 70%, the "resilient" one to be 63% or lower; 60% of all banks managed to be in the "resilient" cost area over the last credit cycle. This does not mean that a clear focus on cost remains key, but in order to improve the overall position, those banks might consider taking a look into asset mix and growth strategy in the first place.

Chart 8: LTROE depending on different long-term levels of CIR (with extreme values)

The optimization of operational efficiency is important, but limited in effect, once a long-term CIR of 63% or lower is achieved



The second quintile banks with cost-income ratios (CIR) between 63% and 70% on average should look closely on the cost matter, but with the exception of 2–3 banks, LTROE is not lowered too much (still giving an average disadvantage of 3–4 PP).

The 13 banks with CIR higher than 70% on a nine-year average, among them some prominent players, should reflect if their banks were designed for shareholders or more as “earn-out” schemes for managers and employees. In contrast to all other banks in Chart 8, the high-cost institutions face high-earnings volatility, too. As a consequence, incentive structures, global branch networks, complexity and overhead costs all need management attention. Except for no-growth, a long-term CIR of over 70% therefore calls for immediate action by the top management.

Not often debated but nonetheless interesting are market shares and market concentration of the top five banks in the different European countries, widely accepted as an indicator of market concentration. The latter defines the “relative market share,” computed as the market share of a bank divided by the cumulative market shares of the top three banks. Key to the result for the sizable German market is whether one takes savings banks and cooperative banks as “consolidated” groups or not. Following the Bundesbank statistics, we did not consolidate these groups, though this could be seen differently (as with the European Commission). In other words, in Chart 9 local banks are positioned in the “low relative market share” bar, even if some of them exercise strong local market power.

Chart 9: LTROE correlated to different levels of relative market share (averages with extreme values)

High relative market shares improve LTROE, but ‘niche players’ could achieve solid LTROE figures, too

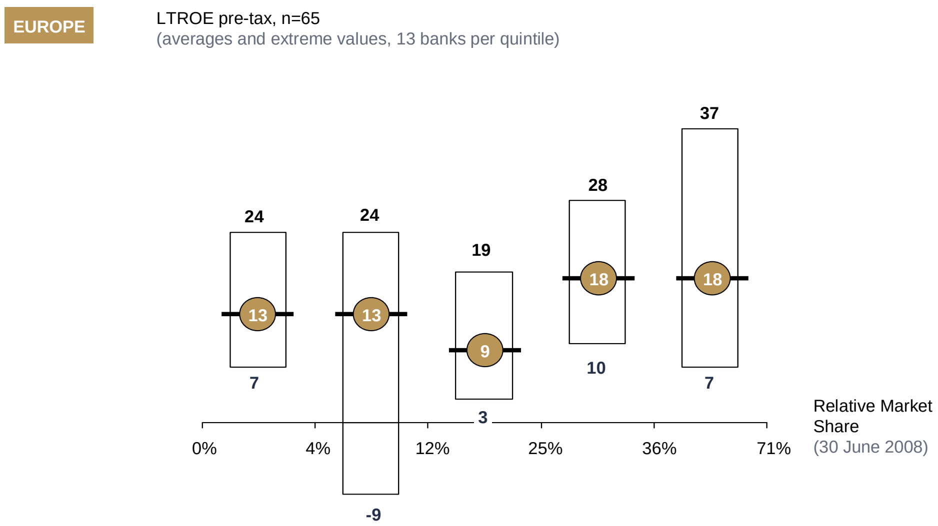


Chart 9 underpins the importance of high relative market share (RMS) for banks; 40% of all institutions already enjoy RMS of 25% or more, implying that their share of the market equals at least one-quarter of the one dominated by the top three. In other words: these banks are already “champions” in their countries because they need be a top three bank. Interestingly enough, smaller countries like Austria, the Netherlands, Portugal or Switzerland all show an oligopolistic market structure as giving their banks some competitive advantages. As we have seen in the discussion of size, however, small and concentrated home markets are not sufficient to create resilient international institutions.

That small banks performed in line might be a little bit misguiding here because a lot of specialized institutions are included. What is again evident is that players that were “stuck in the middle” ended up with the worst average LTROE. These banks neither have their home market under control, nor do they focus on a product or regional niche.

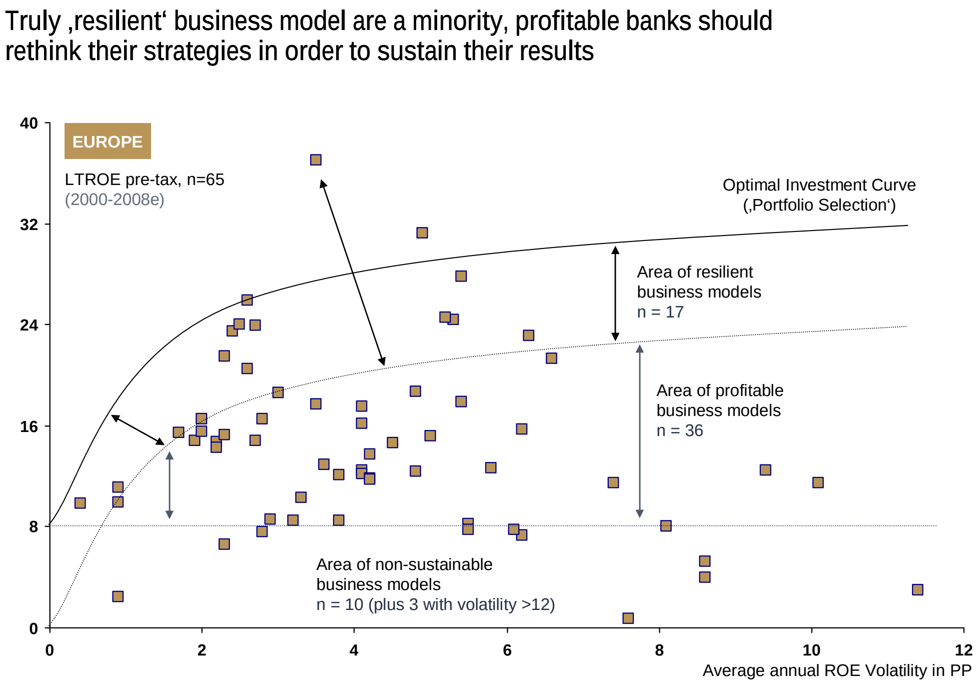
5.
Conclusion:
What to do next?

5.1 Profitable growth through resilient business models

From the previous chapters, we learned that even in a relatively stable and positive economic upswing, only a minority of banks were able to develop truly "resilient" business models. However, with an overall LTROE average of 14.6%, the previously defined LTROE hurdle of 8.0% was matched by most European banks over the full cycle (see Chart 10). According to recent Goldman Sachs research, brokers estimated the overall LTROE for the next cycle to be at about 12.0%, mainly due to higher requirements for core capital quotas.

In chapter 5 we looked at individual banks rather than on quintile groups of 13 institutions each in order to deduct relevant strategies toward resilience. In addition, we now differentiate between "profitable" and "resilient" banks, whereby the former achieve LTROE higher than 8.0% and the latter 'on-top' attractive volatilities compared to their underlying LTROE. The remaining group of banks is neither "profitable" nor "resilient." Some of them provide valuable "infrastructural" services, while others are just "value destructive." The latter should exit the market one day.

Chart 10: Overall universe of 62 out of 65 banks in the Markowitz portfolio (three banks with average annual volatility of more than 12 PP)



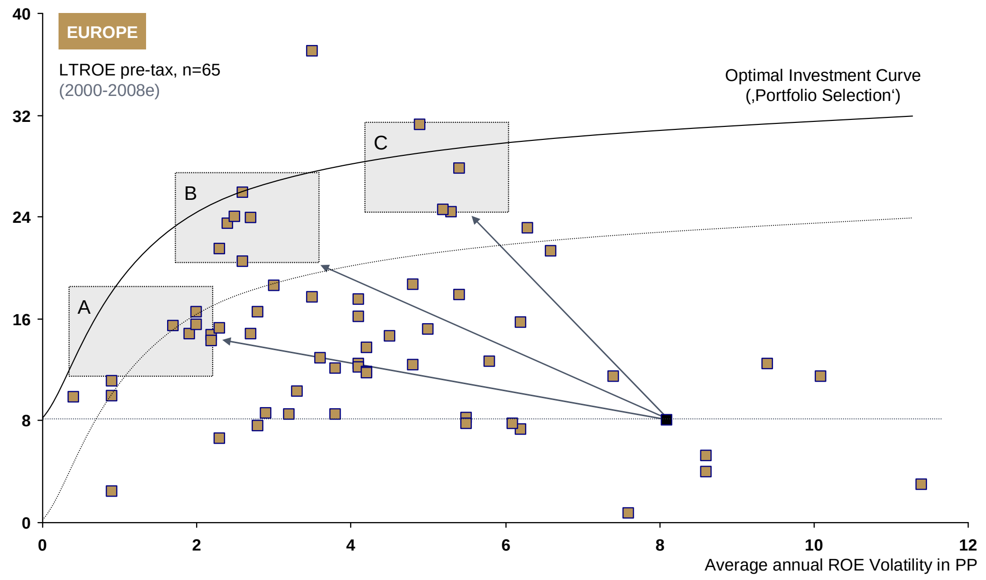
The relatively low LTROE hurdle of 8.0% explains why 50 out of a total of 65 banks appear to be at least "profitable." Appling a higher pre-tax COE of 12.0% as discussed earlier would reduce the number of banks that should remain in their markets to close to 55% of all banks—in our view not a very realistic scenario for the next credit cycle. In Chart 10 we only defined a mere 17 banks out of 65 to be "resilient."

For practical reasons, banks with large "wholesale" exposures could not raise their relative proportion of "customer business" in the short run, especially if some assets were not liquid. But we expect that the announcement to give customer business more weight will send the right signal to the capital markets, to employees and to customers. Other options to enhance the asset mix lie in shortening the balance sheet total and in the establishment of special purpose vehicles (SPV) for doubtful assets, better known as "bad banks." For savings banks and cooperative banks, additional potential lies in intensified vertical integration with primary banks, too. If none of these strategies is applicable, a niche focus remains an option.

Chart 11 illustrates an example situation. "Case bank" was able to achieve an LTROE of 8% with an annual volatility of 8 PP. Although showing profitability, this seems to be a quite "stressful" situation for shareholders and management and not a “resilient” position by any means. In order to select the right strategy, it is helpful first to analyze why the bank is in this delicate corner of the portfolio. Let us assume that the CIR was on average 70%, that growth was poor and that most of the balance sheet was “wholesale” driven.

Chart 11: Selected strategic options for “case bank”

We propose different strategy corridors for “case bank”



The defensive strategy (A) shown in Chart 11 could be achieved through enhanced customer focus in combination with tight cost control. Due to the fact that “classic” businesses normally need lower CIR, the shift in the assets mix might help to partially fix the cost issues, too. Taking over or merging with a “defensive” type bank could ease the way to the resilient position (A) as well. Growth strategy (C), in contrast, appears to be aggressive in character. Management in this situation would prefer to create a solid growth story, keeping the volatility higher than in (A) or, in the balanced case, (B). If our discussion in chapter 2 remains evident, higher growth rates by nature lead toward (C).

5.2 Development of a long-term M&A agenda

If we consider that for a lot of institutions “grow or go” is an imperative, the number of European M&A opportunities will remain high. An important factor will lie in the avoidance of situations where two potential partners double already-existing weaknesses. Betting on cost synergies alone might be misleading in these situations. From this point of view, a combination of UBS and CS Group does not make a lot of sense. The same holds true for horizontal mergers of German Landesbanks. We assume that M&A activities will succeed mainly in cultural areas with homogeneous management styles, for example in Germany and Austria, in France and Belgium or in Italy and Greece. The airline industry is a good role model here.

If managers on both sides of a transaction know where they will start from in terms of LTROE/volatility, it will help a lot to narrow down the number of potential acquisitions.

5.3 Business design with new tool kit

Putting one's own management tool kit into a new framework always creates some reluctance on the management side. However, we believe that making use of an extended strategy toolbox that includes risk components might help senior management to promote "defensive" and "balanced" strategies effectively. We assume that the announcement of relevant risk levels for offensive and defensive strategies might lead to a situation that makes investments easier to quantify for investors. If the management were able to put an earmark on expected growth rates and asset-mix effects of selected strategies, this would further enhance trust in their strategy setting.

A new, enhanced tool kit might lead to a situation where even decision-making in day-to-day business becomes easier. Once long-term strategies are properly understood and backed by the supervisory boards and shareholders, the importance of short-term announcements and actions will cease. In addition, the incentive to act in an entrepreneurial way and to run the business within a stable framework will make results more "resilient." At least the chance for "resilient" results would be enhanced.

5.4 Adjustment of key management figures

The number of relevant management figures significantly increased in the last decade. Management reports often became large-volume Excel spreadsheets delivering hundreds of different numbers to the top management, often on a monthly basis. At the same time, the data set provided to the supervisory board often remains quite restricted in depth.

We propose to add new components to ratings and analyst reports, to some part already realized in Goldman Sachs analyst reports. Providing investors' insights into the relative position of a bank in terms of growth, asset mix, LTROE and volatility would allow for better decision-making, especially when applying long-term figures rather than short-term trends. What investors, customers and government officials expect are not only announcements of high levels of prospective ROE, but also some evidence about the empirical likelihood that these targets will be realized. Chart 12 provides a top-down dashboard of only 10 management figures and measures:

i. Two resulting figures: risk and LTROE;

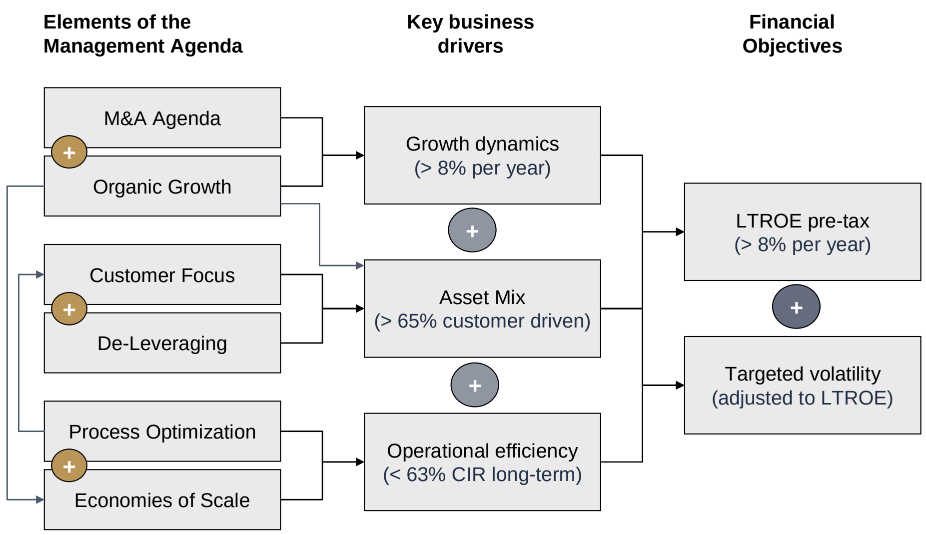
ii. Three relevant drivers: efficiency (CIR), balance sheet mix and dynamics of growth;

iii. Six dimensions that should be discussed in the presentation of each management agenda: M&A and organic growth, customer focus, leverage, process optimization and economies of scale.

It is evident, however, that the drivers will influence results and the six elements of the management agenda will impact the three drivers accordingly.

Chart 12: Simplified model for strategic management orientation, including different target figures for risk and LTROE

An integrated management of the most relevant key business drivers allows management the implementation of tangible objectives and measures



Let us assume the management would like to attract new capital by announcing a ROE objective of 20% of pre-tax, an outperforming ambition in most markets (yet not in all). Combined with a targeted volatility of no more than 3.5% each year, investors could expect to earn between 16.5% and 23.5% each year without adding market turbulences into the equation. If the management is able to demonstrate how growth could be achieved (ideally split into M&A and organic components), how cost discipline will be maintained and how the business mix and leverage should look, the objectives could be “wrapped” into a consistent and credible investor story. The more dimensions remain un-discussed, the higher the level of ambiguity and reluctance of shareholders at the end of the day. More so, if the management is clear on targets, drivers and measures, it should be easy to create a top-to-bottom management-by-objectives (MBO) system that allows middle management and employees to perform against understandable targets.

Doing everything at the same time will quite likely jeopardize the intended effects. Therefore, a focus on one, maybe two drivers is recommended. For example, management could put emphasis on cost management in year one. After accomplishing that, it could go on with pursuing its growth agenda. Announcing one main area of activity in one year and performing against it while keeping the two other dimensions in check appears to be a very solid way to deliver on “resilient” strategies.

6.
An agenda for Europe's top five banking markets

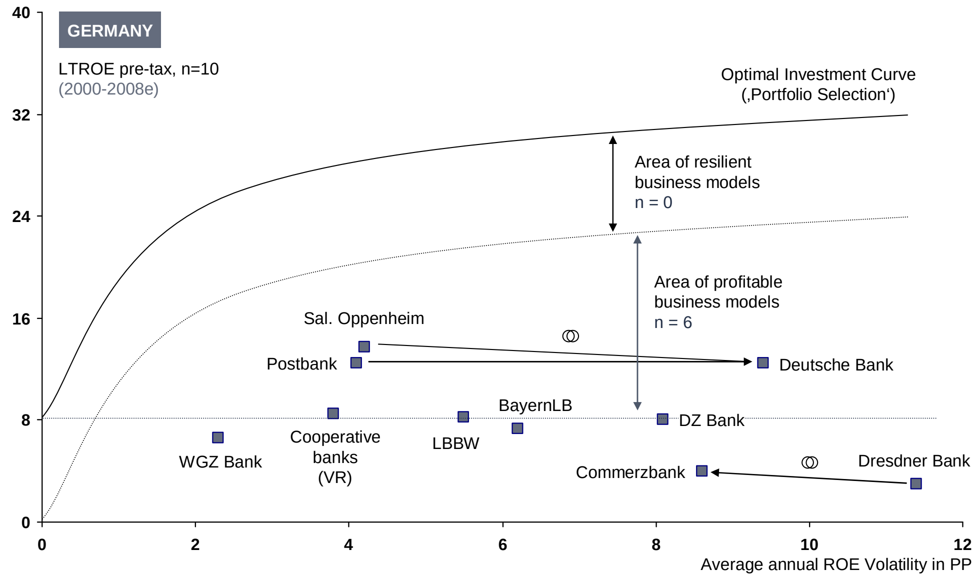
Generally speaking, there is room for improvement for each bank in our survey. Claiming that the competitive or regulatory framework set by local and European supervisory bodies hinders the achievement of resilient results should not be accepted as an excuse. The core management function of top bankers remains to define the drivers of growth and to optimize customer service (in terms of processes and prices). As discussed in the previous sections, we would advise top managers not only to focus on their cost positions but to take a thorough look at growth options and their balance sheet mix as well. At the end of the day, it remains the customer that counts. Customer value transfers into shareholder value as we can see from the survey data.

6.1 Germany

Although Germany is by far the biggest economy in Western Europe in terms of GDP, its banking market with a balance sheet total of about EUR 7.7 trillion is only as sizable as its French and UK peer markets. Historically, the structure of the German banking market differs from all other European markets in the dominance of the state-owned savings and Landesbank sectors, which control between 50% and 60% of the market.

Chart 13: German banks' relative position in the Markowitz portfolio (2000-1H 2008)

German banks demonstrate low levels of resilience due to strong competition of Savings banks and Landesbanken



The understanding of this particular market structure helps in the analysis of the specific results of our survey. With not even one "resilient" business model in banking and only three clearly "profitable" banks over the cycle, it seems as if there is a fundamental need for change.

First of all, it is interesting to note from Chart 13 that the three clearly profitable banks will be all consolidated under the roof of Deutsche Bank AG—Germany's number one bank—in due course. As demonstrated in the previous chapters, these two acquisitions pave the way for Deutsche Bank AG for a more customer-driven, conservative and resilient business model. However, with a market capitalization of about EUR 30 billion at the end of 2009, Deutsche Bank still remains vulnerable to takeover. The announced initiatives to grow business in Asia might add further value to the group through business dynamics. As for the markets in Poland, Italy, Spain and the Netherlands—where Deutsche Bank has achieved reasonable regional market share—the main question will be how those markets could be integrated into a truly European product and distribution platform.

Aside from Deutsche Bank AG, there is only one banking group with a reasonable chance of achieving a resilient, growing and profitable business model over the forthcoming credit cycle: the cooperative banks (VR Bank) including their two central banks, WGZ Bank and DZ Bank. We expect that these banks will profit from higher margins in their classic strongholds of retail and small-cap business, while competitors will either drop out of the market or will be forced to reduce their assets substantially. An additional option lies in the “exports” of market-leading retail and leasing products, where the German cooperative banks hold clear competitive advantages in terms of economies of scale. Austrian, Italian and CEE banks are open to distribute those products based on commercial agreements or minority shareholdings.

The merger between Commerzbank and Dresdner Bank was not the milestone in the German consolidation process that one would have expected. Both banking groups faced similar problems in the past and are now confronted with a situation that will leave the management very limited room for maneuver. The business model of the bank needs not only a “facelift,” it calls for a full reengineering that is unlikely to happen in the short- or medium run. Even as a target for a European cross-border consolidation, the new Commerzbank in its current state is an unlikely candidate. We expect the already dominant state influence to grow further. This would lead to a situation similar to the one with the Landesbanks. The European Commission will sanction further state intervention with unclear consequences.

The fate of the Landesbanks – among them LBBW, WestLB, BayernLB, HSH Nordbank and BayernLB (NordLB, HeLaBa and BerlinLB not in our survey)—will be the pivotal question regarding the future attractiveness of the German banking market. If the local savings banks are forced to participate in the restructuring processes through debt-to-equity swaps, the public sector banks will not have the capacity to defend their market-leading positions in the future. Possible strategies out of the existing dilemma lie in regional mergers and IPOs of savings banks following the Italian case of UniCredit, vertical integrations of Landesbanks and savings banks or a mutualization of savings banks (the case of the French Caisse d’Epargne). It seems too late now to copy the example of Autria’s ERSTE Bank.

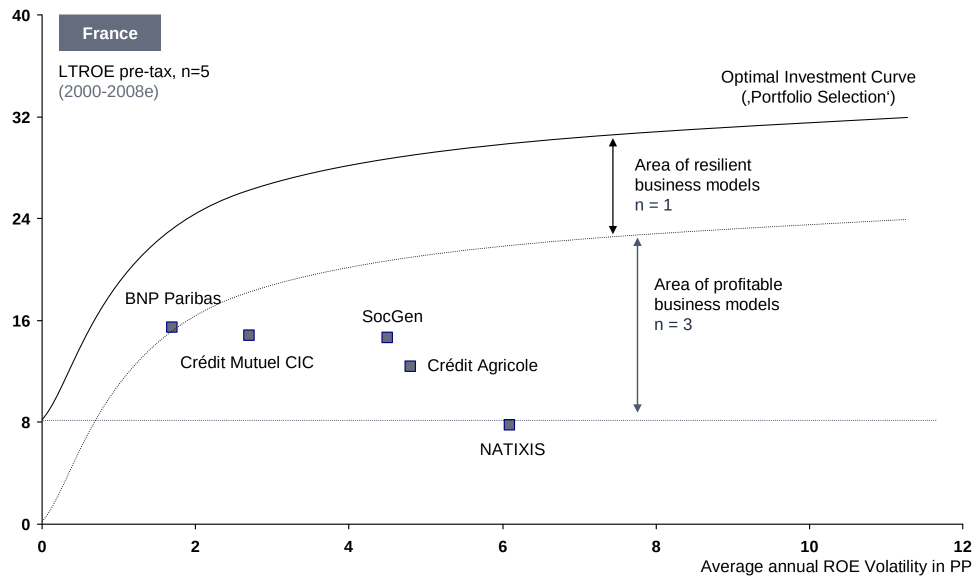
By the end of the next full credit cycle (2015/16), the German baking market will look fundamentally different, most likely with Deutsche Bank AG and the cooperative banks as the likely winners.

6.2 France

Like its neighbor Germany, France has quite a tradition of state intervention in core industries such as electricity, transportation, telecommunications and financial institutions. In contrast to general market logic, one can see from Chart 14 that over the past nine years, French banks have shown a *negative* correlation between risk and volatility. We see this as an indicator that basic market mechanisms have not been working properly, at least over the last decade.

Chart 14: Relative position of French banks in Markowitz portfolio

French sample overall profitable, although only BNP Paribas with a truly resilient business model over the last business cycle



BNP Paribas—already the winner of the consolidation period in the late 1990s—turned out to have the only "true" resilient business model among the French banks. This analysis is in line with most activities implemented by BNP after the peak of the world financial crisis in September and October 2008. BNP Paribas was able to take over and integrate FORTIS in Belgium while at the same time strengthening its position in already existing markets such as Italy and Germany. From June 30, 2008, to December 31, 2009, even the share price soared by 4%, outperforming the EuroStoxx banks by 25%. Next to BNP Paribas, the Crédit Mutuel has demonstrated resilience within the framework of our analysis. Although non-listed on the Group level and being a mainly domestic player, Crédit Mutuel was able to profit from the takeover of commercial bank CIC and from its wide customer base, the second largest next to Crédit Agricole. By means of conservative risk management, investments in capital markets assets were limited. With the acquisition of Citibank Privatkunden AG in Germany, Crédit Mutuel recently entered the German market through a bold move and at a strategic price.

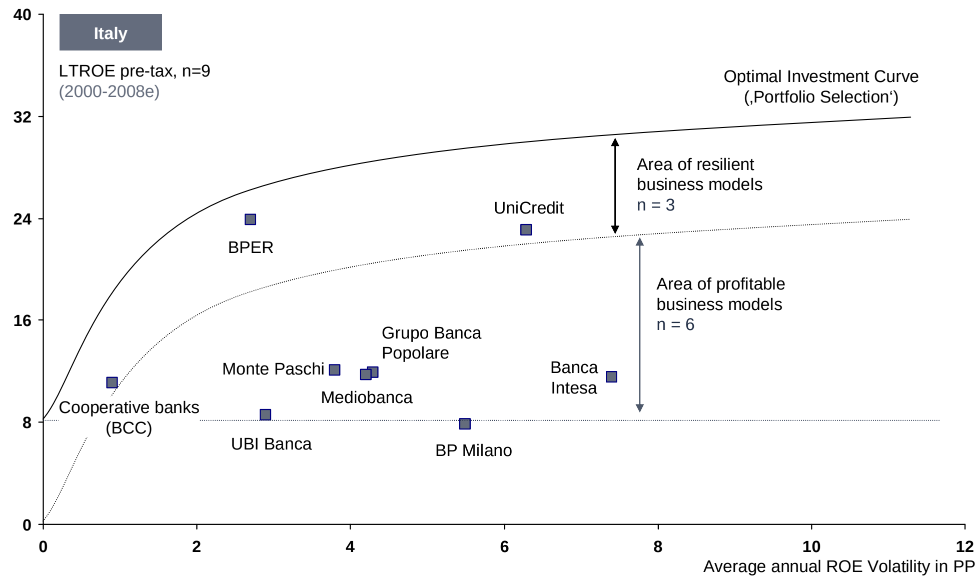
Although cooperative banks in origin, both NATIXIS and Crédit Agricole invested heavily into capital market assets in order to catch up with Societé Générale and BNP Paribas. Even before the world financial crisis took full effect, this strategy was likely to fail. We expect these two groups to concentrate on their respective core functions as central banks to their sectors. As for Societé Générale the results were not fully in line with the associated risks taken by its management. In order to close the gap with BNP Paribas, a merger with one of the remaining French banks or a takeover of a bank in Belgium or Germany would mark the logical next step, otherwise the bank itself will be targeted for takeover.

6.3 Italy

The Italian market in the 1990s lacked a national champions and was—next to Germany—the least consolidated of the top five banking markets in Europe. Through two waves of consolidation, this set-up has changed, with Intesa San Paolo and UniCredit becoming national champions and Banca Monte dei Paschi as an ambitious third.

Chart 15: Relative position of Italian banking groups in Markowitz portfolio

In Italy, clearly focused regional banks such as BPER and BCC are the most resilient - UniCredit profited from CEE growth



Somewhat ignored by the financial markets, popular banks ("Popolari") and cooperative banks ("BCC") still control about one-third of the market. In our analysis it turned out that two banking groups in the Italian sample demonstrated strong resilience: the BCC sector with some 400 primary banks and BPER, the popular bank of the core industrial region of Emilia-Romagna. Both groups refrained from entering into high-risk and high-volatility investments while at the same time demonstrating cost discipline. This is what marks a difference to BP Milano and UBI Banca, both located in the highly competitive region of Lombardy.

All Italian banks were relatively cost-efficient by European standards. The volatility of results of Banca Intesa San Paolo and MPS over the course of the cycle was to some extent caused by the one-time costs of integration of different competitors. Once all takeovers are fully digested, we expect these banks to move naturally leftwards into less volatile segments of the portfolio, making them even more attractive for international investors.

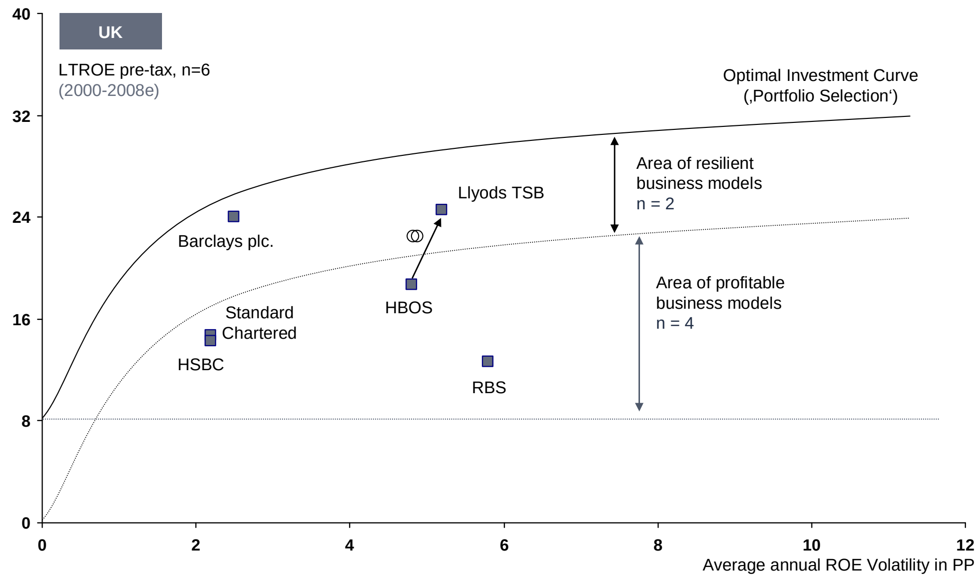
UniCredit Group is exposed to second-wave effects of the economic downturn in the CEE countries. In a long-and-deep recession scenario, this credit exposure might be a threat. However, if the European Union could avoid this worst case, UniCredit is perfectly suited to further exploit its position as the only "true" European leader of the Italian banking market. The share price of the bank performed almost in line with its peers in the EuroStoxx banks index over the last 18 month, proof of the resilience of the UniCredit business model even in turbulent times.

6.4 United Kingdom

Second to no other big banking market in Europe, the United Kingdom was hit hard by the financial crisis (considering Switzerland and the Netherlands to be intermediate-sized markets). However, as significant capital increases of all leading banks in 2009 showed, the trust of international investors in the resilience of UK banks has not disappeared at all.

Chart 16: Relative position of main UK banking groups in Markowitz portfolio

UK banks demonstrated profitable business models due to attractive margins in the home market and in emerging markets (SCB, HSBC)



Historical data alone does not necessarily provide accurate forecasts for the future. The analysis of the 65 European banking groups in the long period between 2000 and 1H 2008, though, demonstrates clearly that there is a lot of value added and resilience in most UK banks, maybe with the sole exception of RBS.

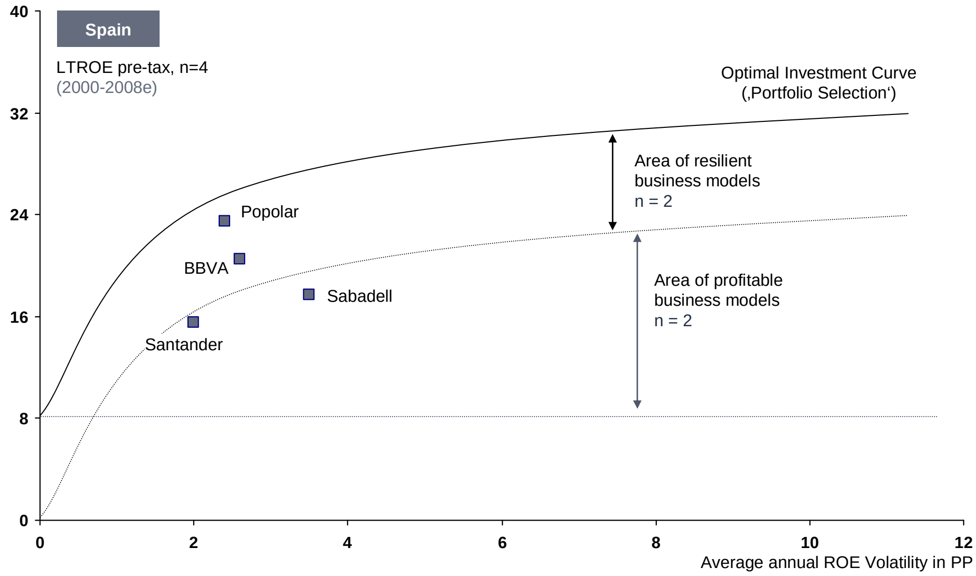
For the top three—Barclays, HSBC and Standard Chartered—we see no need to change business models fundamentally. Growth momentum will remain a key success factor, and may be hardest to achieve for Barclays. The second challenge for Barclays will be how to deal with higher volatility coming out of the integration of Lehman Brothers investment banking business. As for Lloyds/HBOS and RBS, the most important objective will be the reduction of their risk exposures.

6.5 Spain

Of the top five European banking markets, Spain is the most concentrated one in terms of dominance of the two main groups: Santander and BBVA. Except for a strong regional rival, La Caixa, mainly active in Catalonia, very few banks really compete with the top two in the rest of the country. On this de facto duopolistic basis, it is quite straightforward to conclude that Spanish banks are profitable not only in absolute terms but also resilient in terms of risk-return performance in the long run.

Chart 17: Relative position of main Spanish banking groups in Markowitz portfolio

Spain by far the most resilient banking market over the period - impact of world financial crisis limited by strong Latin American presence



But there is more to it than just market concentration in the home market. Like the Austrian banks in CEE, the two leading Spanish banks entered into the emerging Latin American markets early on. By this means they realized above-average growth rates over the cycle and diversified their businesses effectively without losing focus on customer-driven businesses. Even if the Spanish real-estate bubble causes large-scale write-offs, it appears logical to conclude that this will not affect the resilient position of the Spanish banks in the long run. This is not only the result of our survey, it is also the point of view of the financial markets, which show a rise in the share price of Banco Santander of about 8% in the 18 months following the survey, an outperformance of the market of no less than 29%.

One might conclude that the Spanish and the UK banking markets are "role models" for other markets. We see an underlying ambiguity between stable, resilient markets and market effectiveness from the customers point of view. Stable and attractive banking markets lack transparency and could lead to higher prices and mediocre service characteristics due to oligopolistic competition.

6.6 Outlook: Introducing the "Berlin Index" for resilience

We expect that after the crisis, the right strategy to achieve truly resilient business models in banking will lie in a balanced focus on growth, asset mix and cost-to-income management. We expect further that the measurement and reporting of risk relative to return will become more important for all relevant stakeholders, including governments, taxpayers and institutional creditors.

Looking on the Beta (β) in the CAPM model alone will not be sufficient to evaluate the risk in banking models correctly. Volatility should be measured in the context of all relevant market players. It is reasonable to expect that an important part of Europe's banking market in the future will still be controlled by non-listed banks such as the German Landesbanks, savings banks or cooperative banks. In other words: a measurement of volatility of all market players based on over-the-cycle changes in pre-tax ROE might give new and more accurate insights to both investors and regulators.

The authors propose to introduce an index ("Berlin Index") showing different levels of resilience measured on a ten-year and five-year basis. Similar schemes are already in place in the retail fund industry (Morningstar). It is interesting to note that leading asset managers such as those at insurance companies in Europe were almost unaffected by the crisis due to their fundamental understanding of long-term risk. We expect that bank managers could adopt the same levels of professional risk management, too.

For the period of 2000 to 1H 2008, we would have picked 13 banks out of a sample of 65, thereof 8 listed companies and 5 non-listed groups:

- **Listed**: BPER, Barclays, BBVA, Banco Popolar, Santander, BNP Paribas, ERSTE and National Bank of Greece
- **Non-listed**: BCC, Rabobank, Raiffeisen Switzerland, Zurich KB and PKO bp

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ESMT European School of Management and Technology was founded in October 2002 on the initiative of 25 leading German companies and institutions. The founders aimed to establish an international business school, based in Germany, with a distinct European focus. As a private institution of higher education, ESMT provides executive education (since 2003) and an international MBA program (since 2006). ESMT headquarters is located in Berlin with a further campus in Cologne. ESMT is fully accredited by German authorities as a private institution of higher education.

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