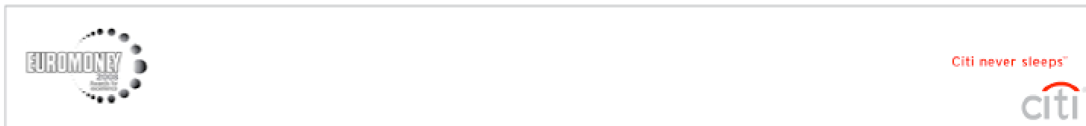

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The future of banking: Why banks need to shape up or sell off

by Helen Avery

Before the September crisis, many banks were looking to sell non-core assets to raise capital. Now, safety in size means mergers are the order of the day. But when the market settles, will investors demand that banks concentrate on what they are good at to maximise returns?

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Special focus: Banking 2008 and beyond

Bank valuations are at 10-year lows, while capital injections from private equity firms and sovereign wealth funds are drying up. In order to shore up balance sheets and return shareholder value, will they be forced to sell the crown jewels, or should they change their business models? Helen Avery reports.

IN A SURVEY by Allen and Overy of chief executives of FTSE 350 and Fortune 500 companies in the summer of 2007, 21% of financial firms said they expected demerger activity in their sector before the end of June this year. Only in the technology, media and telecoms sector did chief executives foresee greater demerger activity. Demergers seemed the likely route as large financial conglomerates were faced with having to improve their balance sheets. A decade of merger activity had led to inefficiencies at the firms, and streamlining to unlock value seemed certain. Buyers were thought to be plentiful – those that survived the sub-prime storm undamaged would be keen to seize opportunities for cheap acquisitions.

Yet the wait for demergers continues. Bank stocks have plummeted. Keefe, Bruyette Woods' large-cap bank index was down more than 33% over the 12-month period up to August 15. Its capital markets index was down almost 24%. As comparison, the S&P 500 was down about 9%. Capital injections from sovereign wealth funds have dried up, having lost around 50% of their investments in firms such as Citi, Merrill Lynch and UBS. Capital-raising in the public markets has been exhausted. How else can these banks shore up their balance sheets if not through starting to sell off parts of their businesses? It can only be a matter of time.

As yet, divestitures have been few and far between. The large banks so far have limited themselves to asset sales and sales of small businesses, or controlling interests, rather than selling off or spinning off entire business lines such as investment banking, wealth management, retail banking or asset management. Merrill Lynch followed several other large financial players by getting out of insurance with the sale of its life insurance business last year to Dutch insurer Aegon for $1.3 billion. It also sold its middle-market commercial finance business to GE Capital, and this year has announced the sale of its 20% ownership in Bloomberg and its controlling interest in Financial Data Services. Citi, which ditched its insurance business back in 2005, has this year sold off Citistreet, its benefit servicing business with State Street, to ING, and its German retail banking operation. Bank of America sold its prime brokerage business to BNP Paribas.

RBS is also expected to sell off small parts of its business. Plans to sell its UK car insurer subsidiary, DirectLine, have been shelved but its ABN Amro units in Australia and New Zealand seem to be on the block, as, possibly, is its Spanish insurance joint venture. Barclays announced the sale of its insurance unit to Swiss Re in August.

It makes sense, says one analyst. "Something has to give and it is going to be the non-core smaller business lines and stakes that go first."

There is still, however, a lack of strong bids in the market that is hindering even small divestitures and spin-offs.

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Allianz searched for a buyer for its banking unit, Dresdner, before making a deal with Commerzbank. Continued volatility in the financial sector had lowered the value of Dresdner's securities unit, Dresdner Kleinwort, which posted a loss in August for the fourth consecutive quarter.

It's hardly surprising that there is a lack of buyers in general, says a UK-based investor. "People keep suggesting that banks in a stronger position, like HSBC, should buy up some of the ailing banks in the UK, but that strategy is absurd. Let the weak banks go bust, and then go after their customers. It's much better to let your competition fail than to use precious equity at the moment to buy them out. Some will find buyers, but I expect two or three will go bust."

The problem with asset sales

If buyers of business lines seem scarce, there are at least willing buyers of problem assets. In May, UBS sold $22 billion of primarily US sub-prime and Alt-A US residential mortgage-backed securities to investment manager Blackrock for $15 billion.

But they may not be enough for the most beleaguered banks. In September Lehman Brothers announced plans to sell a majority stake in its asset management arm and spin off its poorly performing commercial real estate assets, having already offloaded about $6 billion in assets to hedge fund R3 Capital Partners.

But the markets didn't buy into Lehman's plans and, within a week, the 158-year-old US broker-dealer was forced to file for Chapter 11 bankruptcy protection. That said, its asset management business and parts of the investment bank will end up in the hands of new owners once the work-out is completed.

In August, **Merrill Lynch announced the sale of $30.6 billion of US CDOs to Lone Star funds** for an average price of 22 cents on the dollar. It can be assumed that problem asset sales have occurred at all the banks but have been kept out of the public eye.

Selling these assets at a steep discount is certainly painful in the short term. Along with other capital-raising measures taken in August, Merrill Lynch says the Lone Star deal will result in a $5.7 billion write-down in the second quarter. So is it worth it? In Merrill's case it only kept the firm alive until the demise of Lehman Brothers showed it was next in the firing line, and Merrill's board sought to maximize what was left of shareholder value with a sale of the entire business to Bank of America.

Asset sales do not result in the big uptick in share price that a demerger would provide. The main advantage appears to be assuaging investor concerns. Both Merrill Lynch and UBS were praised at the time of the sales for addressing their problem assets swiftly and for attempting to clean up their balance sheets. But some analysts question whether they are merely pulling the wool over investors' eyes. **UBS financed 75% of the $15 billion sale to Blackrock**, so essentially is on the hook for $11.25 billion. "The risks of the assets were not really transferred off the bank's books. Would UBS normally offer a loan of this type with these terms for sub-prime assets in this environment? I doubt it," says Reggie Middleton, a private institutional investor and blogger. Merrill Lynch similarly financed 75% of its Lone Star transaction. As Michael Lewitt, president of Hegemony Capital Management, puts it: "This means that Lone Star is on the hook for the first $1.7 billion of losses, and then Merrill Lynch will eat any losses beyond that. In other words, another $0.05 drop in the value of these securities would leave Merrill Lynch back on the hook for more losses. Either this will prove to be one of the most desperate transactions done in the annals of the current credit crisis, or John Thain knows something the rest of us don't want to know about the real value of the toxic waste he just sold to Lone Star." And Lehman Brothers was a major stakeholder in R3, putting it also "on the hook" if the assets deteriorated further.

Were these banks just delaying the inevitable? While bank write-downs worldwide currently total about $500 billion, with $350 billion in capital-raisings, Elisa Parisi-Capone, lead analyst for financials at RGE Monitor, says we have a long way to go yet. "We estimate $1.6 trillion in system-wide losses as house prices continue to fall – potentially $2 trillion including Freddie Mac and Fannie Mae and the entire non-bank sector. We're going to see more asset sales, but it's just a short-term fix." Statements such as these also fuel concerns that banks are not being entirely honest about their exposure to mortgage-related securities.

While asset sales certainly appear to be more for cosmetic value, there is the possibility that by placing the assets in the hands of more capable work-out specialists, further deterioration will be prevented. "Investment banks are not as skilled in extracting every cent of value on the dollar for these assets and therefore getting rid of them and focusing on what they do best is a good thing," says Jess Varughese, managing partner at Milestone, a financial services consulting firm. "In that sense, it's plausible that by placing these problem assets in the hands of the likes of Lone Star, they will end up minimizing their downside risk."

Short-term fixes they might be, but taking the write-downs through asset sales is seen as a preferred means of improving the balance sheet than capital-raising via the public markets, which has been the predominant route of many banks.

"If a firm is faced with selling an asset at a 20% discount or raising capital that is currently a 40% discount to value, it's preferable to do the former," says Mike Mayo, analyst at Deutsche Bank.

Selling the crown jewels

If divestitures or demergers have been unforthcoming, it is also because banks are cautious about the long-term damage that selling off performing business lines could bring.

Lehman Brothers had been rumoured to be considering the sale of its asset management firm, Neuberger Berman, in addition to selling its stakes in hedge funds DE Shaw and GLG Partners. Lehman bought Neuberger Berman in 2003 for $3.2 billion. Analysts value the asset manager at between $6 billion and $8 billion. To put this in context, the total market capitalization of Lehman on the day it announced its intention to sell a majority stake in the asset management business was under $6 billion.

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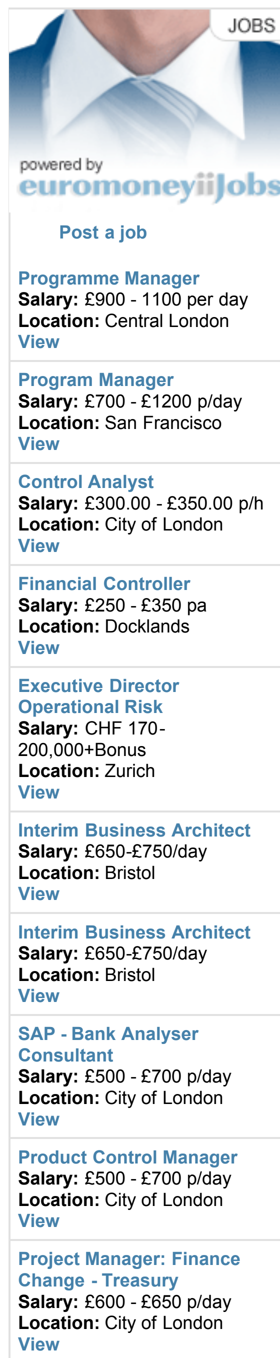

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Merrill Lynch, before its sale to Bank of America, was similarly reported to be toying with the idea of getting out of asset management, by considering selling its 49% stake in Blackrock back to the firm. Merrill Lynch decided against it. Milestone's Varughese says: "Blackrock was the brightest star in Merrill Lynch's revenue picture in the first six months of this year. Sell it, and the firm will have to pay the piper down the line in diminished revenues."

Blackrock took on $24.2 billion in net new money from investors in the second quarter this year, and its share price has almost doubled since Merrill Lynch acquired the stake in 2006. It remains to be seen what Bank of America plans to do with the minority stake it inherits.

UBS chairman Peter Kurer insists he has no plans to sell off its investment banking franchise, despite splitting it off from the private banking and asset management arms

Asset management, indeed, does seem to be the beacon of light in the current financial market. "Asset management businesses are one of the only areas of strong performance right now," says Randal Stephenson, head of M&A and corporate advisory at investment bank Pali Capital in New York. "They are among the only assets of some of these firms that are not considered uncertain and potentially completely at risk, like the mortgage obligations. To break these off would massively subtract value." Investment bank Lazard seems to have realized this point. In August it announced that it would buy out the minority stakeholders in its asset management subsidiary, Lazard Asset Management, in order to boost asset value of Lazard common stock, and diversify and simplify the firm's structure.

Shareholders' silence

Given that asset sales and small divestitures have yet to stem the write-downs that come each quarter, it is a wonder why shareholders have not been more vocal in asking banks to reconsider their banking models and divest or demerge business units. In Allen and Overy's survey of chief executives, 64% named shareholder pressure as a big influence on demerger activity. Hedge fund TCI launched a campaign in 2007 calling for ABN Amro to split its businesses up – an initiative that resulted in ABN succumbing to a £58 billion sale to RBS and its partners, and Fortis. Yet since the credit crunch launched into full swing in the summer last year, pressure from ordinarily vocal activists, such as TCI's Chris Hohn and Carl Icahn, on the numerous financials companies that might benefit from divestitures or demergers has been surprisingly unforthcoming. The two hedge funds named declined to comment but Barry Cronin, CIO of Taylor Advisors, an allocator to hedge funds including activist funds, says he is not entirely surprised that activists are steering clear of the financials sector. "Being able to value the underlying assets of a company is crucial to an activist. In many instances, the assets of these financial institutions are the people and not the bricks and mortar, which makes valuations difficult. Moreover, the assets on the balance sheet of a financial institution have become increasingly opaque. People have spent the last 12 months estimating the value of some of these firms, only to find the value to be much lower at a later point.

"Additionally, the future earnings power of these banks must be called into question. Some areas of their businesses, such a private equity finance and securitization, have dried up. However, at some point, these assets will become so cheap they are worth buying."

The activists' role is made easier when there are strategic buyers ready to step in, such as with ABN's split-up. At the moment, however, it appears that while many are looking, strategic buyers are not yet ready to commit themselves to deals.

Pressure from large institutional investors has also been absent. Several that were contacted declined to publicly share their views on their financial stock holdings. Just how much pressure these investors would want to put on the banks is questionable given the relationships they have with them in areas such as deals, cross-selling, or banking, but with the losses these bank investments have passed on to shareholders, the lack of agitation is surprising. Michael Levas, the CIO of Olympian Capital, a US investment firm, says he too is surprised. "Some of these financial institutions have had a callous disregard for investors. Management has been over-paid, in some cases have received large bonuses on their departure, and have lost money for investors. Investors are owed more than this and I would expect hedge funds and shareholders to be more vocal about their maltreatment."

Christopher Young, head of M&A at Riskmetrics Group, which owns proxy voting business ISS, says there has been some pressure behind the scenes. But it has been focused on compensation packages and the risk-management decisions of upper management at the financial institutions. He argues that it is still too soon for shareholders to start pressuring the banks to reassess their business models. "Investors are trying to get their arms around the extent of the damage, and to work out whether capital-raising attempts are paying off. There is obvious concern that some of these banks will end the way of Bear Stearns, but investors are waiting for some stabilization before making a move. Next year's annual meetings season will be interesting: If the share prices of these banks have not bounced, investors are going to start discussing the elephant in the room publicly."

The brave Knight

To date, the only public pressure for a divestiture at financial institutions has been aimed at Citi and HSBC. In July, Gerald McEntee, chairman of the employee pension plan for Afscme, the US's largest public service employees union, wrote to Win Bischoff, chairman of Citi's board, criticizing the bank's "financial supermarket approach" and urging it to ditch some of its subsidiaries in order "to restore shareholder value".

At HSBC, since early 2007, asset manager Knight Vinke has been pressuring the firm to rid itself of its US subsidiary HFC (formerly Household International). HFC, a US sub-prime mortgage lender, has incurred $25 billion in total losses for HSBC since the beginning of 2006, argues Knight Vinke. Had it been sold, the asset manager claims, HSBC's share price would be 300 basis points higher. The investment manager, which owns less than 1% of HSBC, has also

Merrill Lynch's John Thain sold off his CDO book to Lone Star, and toyed with

criticized the bank publicly for not being honest about the true valuations of its assets and for its compensation packages. In a statement in February, Knight Vinke said: "HSBC's decision to enter the sub-prime business in the US was a catastrophic strategic error. This was a reflection of the group's obsession with the pursuit of geographic diversification instead of comparative advantage. While it would certainly have made a great deal of sense for HSBC to acquire a major wealth management business in the US, what it has today amounts to a business that lends to those least able to repay the loans made to them and one that is probably in terminal decline. In due course, the US property market will come out of its current downturn, but we are of the view that lenders have now learned their lesson and that the sub-prime business that survives (if at all) will be a fraction of the industry spawned by the excesses of the past three years. This is clearly not a business that HSBC should own in the future, regardless of what management says, and the financial costs of downsizing it appear not yet to have been properly taken into account by the market. It also represents a huge distraction for management and may prevent HSBC from being able to acquire the sort of business that would really make a difference, strategically, during this time of opportunity."

raising capital by offloading its stake in Blackrock, but in the end he could not maintain the firm's independence

Knight Vinke's view is not an irrational one, and has been backed up by several analysts. A report by Goldman Sachs in May suggested HFC would require a further $46 billion in order to remain afloat, and, even with such a capital injection, will be worth zero. Stephen Green, HSBC chairman, says the firm wants to draw a line under HFC but has not said when.

It's a difficult situation for HSBC, which has been making big efforts to expand in the US. Ridding itself of HFC would be regarded as pulling out of the US in the eyes of HSBC management, but analysts argue that in this environment, banks need to assess their geographical footprint and the businesses lines that they are in. "There have to be synergies among the business units," says Stephenson at Pali Capital. "At some point these businesses become so large that inefficiencies are tossed into the system. You just are not going to convince me that a retail banking business in New York has synergy with the investment bank in China, for example, or vice-versa. It doesn't." In terms of geographical divestitures, other than Citi's sale of its German banking unit, analysts say French firm Crédit Agricole could sell its stake in Italian bank Intesa Sanpaolo.

In the case of HSBC, analysts have argued that as the bank does well in Asia and emerging markets in retail, commercial and private banking, it should stick to its knitting, as Standard Chartered has. Standard Chartered's first-half profits were up 32%, driven by the Middle East, Africa, India and Asia. Despite a 20% increase in profits in Asia and 63% for the Middle East, HSBC's US sub-prime exposure meant that the firm's overall first-half profits fell by 29%.

The question of sticking to one's knitting and the value of a pure-play strategy has been thrown once again into the spotlight by the financial crisis. Which of commercial banking, investment banking, wealth management and retail banking can ultimately work together? Or are they of more value to be kept apart? Is the financial supermarket just too unwieldy?

UBS's decision to separate its investment banking and wealth management operations indicates a fundamental change in the thinking that the two can work together. In 2005, financial institutions that housed both private banks and investment banks began to make a push to explore synergies between them. Investment banking clients were chased up by in-house private bankers, and high-net-worth clients were flogged structured products created by the investment banking unit. The result has been disaster, and for UBS more than most. In 1998, the Swiss bank Union Bank of Switzerland merged with investment bank SBC (Warburg Dillon Read), and then in 2000 purchased US brokerage and asset manager Paine Webber. The three-pronged approach of investment banking, private banking and asset management was considered a winning formula.

In 2006, investment banking seemed to be pulling its weight in the group: pre-tax profit was just short of SFr5.9 billion ($5.4 billion), and combined pre-tax profit for Swiss, international and US wealth management was SFr5.8 billion.

But by the end of 2007, investment banking and its sub-prime losses were bringing the entire group down. Wealth management created about SFr7 billion in pre-tax profit, while the investment banking operation reported a pre-tax loss of almost $6 billion. After $44.2 billion in write-downs and credit losses, the impact on the lucrative wealth management business is now evident. While the first quarter saw positive inflows into UBS's wealth management and business banking units, clients pulled out SFr19.3 billion of assets in the second quarter this year.

The response by UBS has been to separate the three businesses of wealth management, investment banking and asset management into autonomous units "and vest them with increased operational authority and accountability". It was a move welcomed by the market and, in particular, investment company Olivant, which had been vocal about UBS readdressing its structure. Olivant holds a 2.87% stake in UBS. But not everyone is convinced it will have an impact. Middleton says the move seems little more than "paper-shuffling". He says: "Investors can see risk is risk. If you sell the investment bank, the problems will no longer be there. But spinning it off and retaining ownership is not a solution. It's just simply a means of minimizing the accounting hit on the private bank for now."

Bank chairman Peter Kurer has denied that any of the businesses are going to be sold. But would it be a good idea to get rid of the investment bank altogether? Erin Davis, analyst at Morningstar, thinks private banks are more valuable when not exposed to the risks imposed by investment banks. "The investment bank was really the undoing of UBS. Wealth management was the driver of value for UBS but the investment bank took too much risk. If only they had broken up the group two or three years ago. They are unlikely to find a buyer for the investment bank now."

Davis argues that there is a significant difference between private banking and investment banking that should deter private banks from entering investment banking. "The value of a private bank is unlikely to deteriorate overnight. Clients are sticky and typically do not leave immediately. When things go wrong at an investment bank, changes are often much more rapid."

Model or management

While it is clear in the case of UBS that the investment bank has dragged down the private bank, does this necessarily mean that investment banking and private banking shouldn't mix? Are we really about to see some demergers? Some of the largest investment banks have private banking franchises. Although it might not be in the interest of a standalone private bank to enter investment banking, the diversification it offers the investment bank has clearly been an advantage. As Davis admits: "If UBS had spun off that investment bank two years ago, without being able to lean on the wealth management business, it might have ended up the way of Bear Stearns." Achim Schwetlick, an investment banking leader at Boston Consulting Group, believes there are synergies between the two businesses. "We've carried out total shareholder return studies that show the combination is a good one, and that it is disadvantageous for investment banks to dispose of wealth management businesses. There are operational synergies, particularly in emerging markets where personal wealth and professional wealth are intertwined, as in Latin America and Asia. Ninety percent of the growing private client sector is among entrepreneurs. For the investment bank, doing an IPO for a client often involves looking at the personal wealth side as well. A lot of the executives that the M&A business of an investment bank will be dealing with are also going to have personal wealth, so that interaction enables a reference to the wealth management division. And, thirdly, a wealth management arm is a great distribution channel for structured products, municipal bonds and equity issues."

"If UBS had spun off that investment bank two years ago, without being able to lean on the wealth management business, it might have ended up the way of Bear Stearns"
Erin Davis, Morningstar

The advantages to a wealth manager of having an investment bank are far fewer, but "being able to allocate IPO issues to your private clients is a competitive advantage," says Schwetlick.

Now that UBS has questioned its own model, Credit Suisse, which also operates a three-pillared approach, is under scrutiny. Chairman Walter Kielholz has defended the "one-bank" model. In July he told a German newspaper that calls for the bank to focus on private banking alone were wrong as private banking clients wanted a broad range of services, including investment banking. Having $10.8 billion in write-down and credit loss, compared with UBS's $44.2 billion, the firm is certainly under less pressure to consider a divestiture of the investment banking business. Wealth management clients seem less perturbed by investment banking losses than at UBS. In the second quarter of 2008, Credit Suisse's wealth management business had SFr15.4 billion of net new inflows. Davis says: "An important part of the reason that Credit Suisse has not been nearly as damaged is that the firm was still chastened by the losses it took in 2001 and 2002 – so it wasn't taking on nearly as much risk."

Indeed Davis argues that UBS is in fact mimicking Credit Suisse by keeping its investment banking and private banking businesses apart. "Credit Suisse kept its operations more separate than UBS did, emphasizing cross-selling instead, which helped contain risks that the investment bank was able to take by limiting its access to the private bank's capital. This is probably why Credit Suisse's profitability and efficiency didn't look as good as UBS's at the height of the boom, but also why it didn't get decimated. In the end, if UBS doesn't break apart its businesses, it will probably look more like Credit Suisse than it did before the credit crisis."

Universal winner

Beyond simply private banking and investment banking, the crisis has raised the point of the universal banking model. Have the mergers of the late 1990s and early 2000s created financial organizations whose unwieldy structures have destroyed shareholder value? As yet, the universal banks are sticking by their models. Société Générale's chief executive, Frédéric Oudea, went as far as to say in August that "the universal banking model will come out of this crisis as the winner".

Afcsme's pension plan chairman is less convinced. McEntee points to Citi's 54-page list of subsidiaries that the firm includes in its annual report as proof of the firm having become too sprawling. "The current crisis illustrates the shortcomings of the financial supermarket approach, at least as practised by Citi," he says. "Although supporters of this model touted the benefits of synergies between business units, it turns out that such connectedness can be damaging as well as helpful – witness the impact of sub-prime through different Citi businesses – and the supposed diversification afforded by the financial supermarket model does not appear to have done much to cushion Citi's earnings. The management challenges posed by differing information systems, compensation approaches and cultures are significant and consumers have not embraced the notion of a single provider as enthusiastically as some predicted."

Diversification might not be helping Citi as much as its shareholders would like, but one look at Bear Stearns and it becomes clear that some diversification might be helpful in investment banking. As Parisi-Capone points out: "Do the banks rely on capital markets and short-term funding for finance, or do they have a high deposit base like the commercial banks? Northern Rock was very exposed to short-term funding and had a low deposit base, and it was the first UK bank to hit difficulties." Northern Rock was effectively nationalized by the Bank of England in February this year. The investment banks are likely to suffer in the next round of regulatory changes because of this lack of deposits.

Back to the 1990s

Is capital so bad, however, that we will see investment banks forced to merge with commercial banks, and commercial banks sell off investment banks? Not according to Deutsche's Mayo. "US bank stocks are back to the early 1990s scenario of trading well below franchise value," he says. "Our proprietary model looks at stock price relative to the sum of the parts; many banks are cheaper than they have been in 10 to 15 years, but there is unrealized value. There is so much discussion on whether the write-downs on loans need to be more but there is insufficient discussion on the unreleased values of deposits, processing and overfunded pension plans. It's woefully one-sided and adding back in unrealized values into our models shows the stock prices to be well below

the sum of the parts."

Essentially the model is irrelevant, says Mayo. "This past year has shown us that management trumps model. An investment bank with good management like Goldman Sachs can outperform just as a good universal bank like JPMorgan can outperform." Goldman Sachs and JPMorgan have had write-downs and losses of $3.8 billion and $14.3 billion respectively. In the one-year period up to August 15, the firms' share prices had dropped 8% and 16% respectively, outperforming their peers.

"Investors are trying to get their arms around the extent of the damage, and to work out whether capital-raising attempts are paying off" Christopher Young, Riskmetrics

Management might be crucial but risk has been the biggest decider of which banks – universal, investment, commercial or private – fail or not. Even the banks that appear to have escaped relatively unscathed might have done so at the price of taking on risk. "People are too busy focusing on earnings, no one is measuring the risk of some of the banks that are doing well. When the wind chooses not to blow in their direction, the shit will hit the fan much harder than the rest of the Street," Middleton warns. "I agree that a firm's survival and ability to hold on to businesses is dependent on management capability. But managements are rewarded for performance not for reducing risk at investment banks and this skews decision-making."

If Middleton is correct, more losses are likely to be on the cards and where will the capital come from to bolster balance sheets? Analysts are forecasting around 300 bank bankruptcies. Parisi-Capone says: "We expect room for another broker dealer to go bust. And in terms of the smaller banks, as many as 700 US banks are in the stressed category as of Q1 2008, according to bank analysts."

Consolidation has to occur, says Mayo, but it's still too soon to expect demergers and exits of businesses by the banks. "There are still too many banks given the revenue opportunity, and we expect to see consolidation and restructuring over the next three to five years," he says. "It is too soon yet and with stock prices down as they are and a lack of buyers, we won't see activity until we are through the downturn."

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