The DIBC STRATEGIST

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Dear Friends

Our consulting program since this Spring has been driven in large part by the conclusions of our trio of eminent bank analysts – Pat Butler, Sam Theodore and Simon Samuels – who presented their views on the outlook for revenue growth in banking at our May Planners Forum meeting. Quite simply, banks have been enjoying 'a perfect summer' in mature markets such as the EU, with virtually all of the traditional profit indicators pointing to more difficult times to come.

One of our major client projects has thus been to explore which businesses may offer a durable competitive advantage in a world of commoditization, price-cutting and slower economic growth. We've therefore had a most stimulating autumn of conversations with heads of strategic planning, buy and sell side analysts, and management consultants specialising in the banking world. Our principal article in this edition of the Strategist comments on one such candidate – SME banking.

Another fascinating project has been to explore case studies of success in equity derivatives and structured finance – another topical issue for banks seeking to boost their revenue growth. And we continue to run client seminars featuring best practice case studies in retail and corporate banking. For a client offering a new analytical service to European banks, we've been carrying out a market survey with leading bank CFOs to understand how that service can add value to their work.

And on the executive coaching front, I've completed my work for the MSc in coaching and counselling at Birkbeck College. The pleasant surprise in my work with clients is how well coaching meshes with my career experience in the banking world: they really are two sides of the same coin!

Steve Davis

SME Clients: commercial banking's best-kept secret?

Small business clients provide big results

Where will bank earnings growth in mature markets like the EU come from? As the 'perfect summer' of 2005 draws to a close, bank management contemplates a less happy winter of continued declining margins, low interest rates, price battles for market share, and limited gains from cost reduction programs and improvements in credit quality.

The consultant's standard response to this dilemma is segmentation – and a focus on those segments which might offer sustained competitive advantage. Yet one of the most popular such segments in recent years – the mass affluent client saving for his retirement – has proven elusive. In the words of a friend at HSBC, which partnered with Merrill Lynch in an ill-fated mass affluent joint venture, 'there may be a gap in the market, but is there a market in the gap!?'

Yet one client segment would appear to provide both a durable and profitable source of earnings growth: small businesses with sales of up to perhaps 10 million Euros or dollars. Known as PYME in Spain and SME (small to medium sized businesses) in many other countries, it is one of the least documented segments of the banking world. Banks in the US and EU generally provide ROE figures for their retail and corporate/investment banking divisions, but SME seem to be lost somewhere in the retail or commercial network. There are no league tables or market share data, and only a rare annual prize, such as the business banking award in the UK.

We include as Figure 1 a matrix showing the estimated size and profitability of SME banking in the US contrasted with other lines of business. Provided by Financial Institutions Consulting in NY, which specialises in the sector, achieving ROEs of over 30% after tax would appear to be the norm. As one of our bank strategist friends puts it, 'SME is God's own market' – at least for those with an existing client base.

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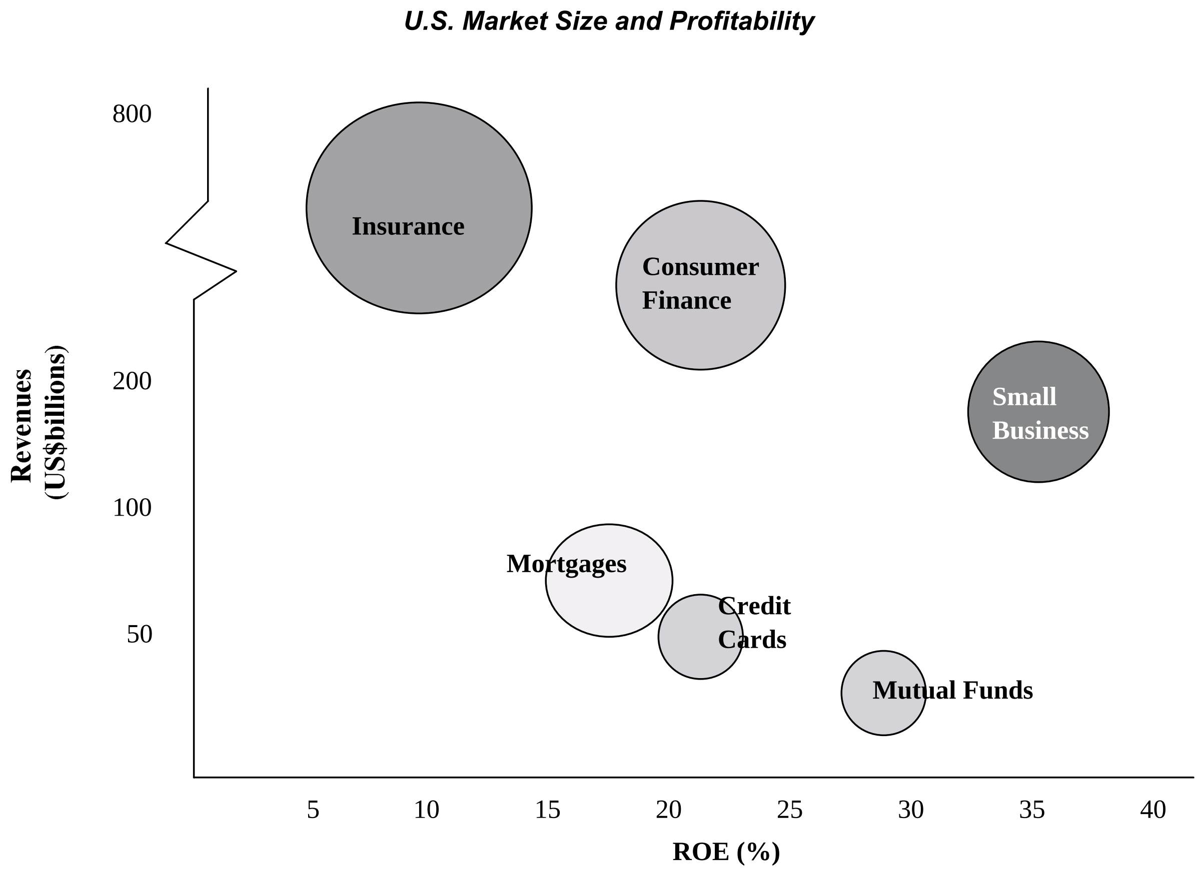
Figure 1: In the U.S., the SME segment generates above market returns compared with other areas



Source: Financial Institutions Consulting

Why do SME's offer such a durable source of extraordinary returns in an increasingly commoditized banking market? For a number of reasons:

- professionals and other small businesses are effectively locked into their lead banking provider even more than their retail counterpart. Switching lead banks - and educating the new banker in the client's credit and other needs - is not a simple task.

- the timely provision of credit can be the deciding factor in the relationship, and the price of credit to the SME is secondary to its availability. The essential glue is the relationship manager's knowledge of the client.

- cross selling personal banking services – in particular wealth management – to the owner or CEO should be a relatively straightforward and remunerative task given the likely close link between personal and business needs and resources.

Yet in many EU markets one hears negative war stories about SME. Significant credit losses in the early 1990s in markets like the UK and Germany seem to have been suffered. More generally, the cost to serve these relatively small accounts is often seen to be too high to generate a useful profit. In organizational terms, the SME may fall between two stools: the retail network is not organized to provide the service levels demanded and the corporate or commercial sector cannot be bothered with such small and unsophisticated borrowers. A straw poll of our banking friends found none who compute ROE for the segment for their management information system.

For those who have worked extensively in the SME sector, the lessons of experience confirm that success in SME banking indeed requires a specialist approach.

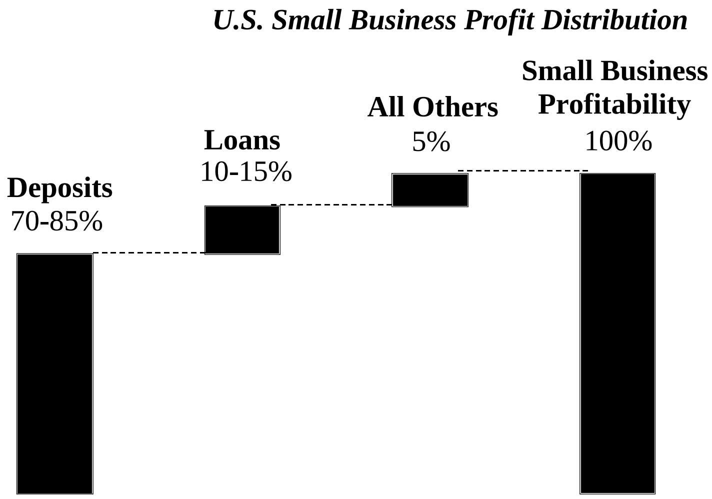
These lessons include the following:

- for SME clients in general, deposits rather than loans or other services are the main driver of profitability for their bankers. Figure 2 profiles the relative contribution from a US study by FIC. Thus for bankers uncomfortable with SME credit risks, the sector can still provide substantial deposits at modest rates.

- a logical segmentation within the SME world is between active borrowers and deposit generators. Figure 3 provides such a breakdown. Happily, experience shows that the skills of a relationship manager specialising in deposit gathering are quite different from those demanded of one who generates loans.

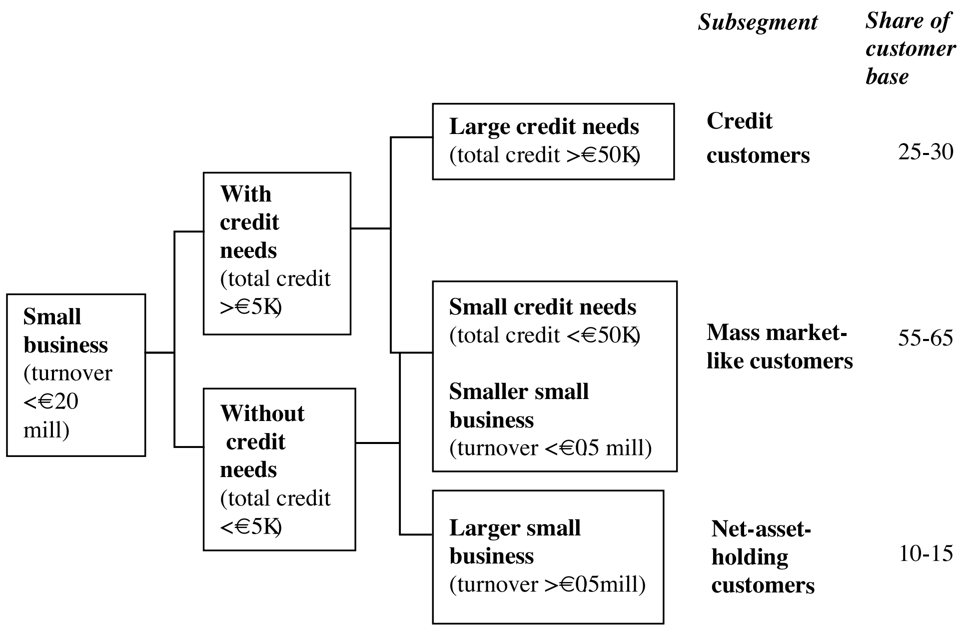
- credit and administrative processes must be tailored to avoid admin overload for the relationship manager, Thus few seem to be able to spend the recommended best practice commitment of two thirds of their time on client service and marketing. Credit scoring, pre-approved credit lines and simplified, on-line procedures seem to be essential to achieve this objective.

Figure 2: Deposits drive profitability



Source: Financial Institutions Consulting

Figure 3: Subsegments of a leading small business bank



Source: McKinsey & Co.

Spurred by these insights, we recently undertook for a European client a brief survey of the EU and US banks who seem to have successfully addressed the SME challenge. The list is impressive and includes the following:

- in the US, Wells Fargo and Wachovia Bank are widely seen to be SME leaders. Wells, for example, with its Business Express, is believed to be the largest SME lender and operates a totally on-line, nationwide facility supported by relationship managers based in a central location. Wachovia's Business Relationship Banking Access offers a similar capability.

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- the Irish banks – in particular Anglo Irish Bank – have won accolades at home and abroad for their approach to SMEs. Anglo-Irish's achievement is particularly remarkable in its use of centrally based, rather than branch-based, relationship managers.

- Banco Popular Espanol, one of Europe's most profitable retail institutions, has built its medium term plan around penetration of the SME market, which fits its unique approach to affinity group banking

- We believe UniCredit, another thought leader in EU banking, is shifting its focus in its home market away from the mass affluent segment in the direction of SME banking.

- Svenska Handelsbanken, well known for its decentralized culture and organic penetration of new markets, is focusing on attracting SME clients as it builds in the highly competitive UK market.

Building a SME capability is certainly not clear sailing. Breaking into the business, as Alliance & Leicester is attempting in the UK, is far tougher than revamping an existing capability. Typically a large branch network is needed to provide the money transmission service most SME need. Thus Anglo-Irish's success is largely a function of its focus on the credit product. Too much vertical hierarchy also seems to get in the way of customer service. And relationship managers need training – and increasingly an incentive compensation structure to motivate them.

Yet we believe SME banking, properly executed, should produce superior results compared to banks' less than totally successful efforts to penetrate the mass affluent market. Marketing consultants shake their collective heads over the banks' difficulty in creating a distinctive brand for their institution. They wonder whether banks can really apply the focus needed for this brand and the resulting ability to charge for it. We suggest that SME banking is both capable of providing a durable, highly profitable business – and to support the brand that banks are striving to achieve!

Steve Davis

An invitation to the International Bank Planners' Forum

The International Bank Planners' Forum (IBPF) was formed in 1990 at the instigation of DIBC. The Forum provides an opportunity for key individuals charged with the strategic development of their financial institutions to meet to discuss and debate issues of common interest. The membership now consists of approximately 20 leading banking institutions in Europe and the US.
The Forum meets twice yearly (May and November) in London and DIBC acts as secretary. The next meeting is scheduled to take place on the 10th & 11th November 2005. The Friday session of the meeting, open to non-members, has the following agenda:

- Trends and issues in global investment banking:
  Maureen Erasmus, Managing Director, EMEA Corporate Strategy
  Merrill Lynch International
- How a Leading US bank plots its domestic and international strategy:
  Bob Kelly, Chief Financial Officer
  Wachovia Bank
- A uniquely successful corporate banking model:
  Ronan White, Senior Manager, Treasury
  Anglo Irish Bank
- Summary of current trends and issues in global banking:
  Steven I Davis, DIBC

Membership of the IBPF is open to all banks, with membership fees as required to defray the Forum's meeting costs. The cost of the open session to non-members is £300 plus VAT. If you would like further details of membership of the IBPF or attendance as a non-member at IBPF meetings, please contact Lynn Manek at DIBC.

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