

## What Banking Needs to Become by Vanessa Wallace and Andrew Herrick

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**Regulations and consumer expectations are changing. The business models, capabilities, and practices of the financial-services industry must change with them.**

# WHAT Banking Needs TO Become

by Vanessa Wallace and  
Andrew Herrick

**For all the chaos in the global economy since early 2008, some things have not changed.** The vast majority of banks that were in business then are still standing. The purpose of banking is the same. Banks provide a safe haven for the savings of individuals and businesses, they support productive human endeavor and economic growth by efficiently and effectively allocating funds, and they bridge the divergent maturity needs of short-term depositors and long-term borrowers. If the global financial crisis has demonstrated anything, it is the continuing and essential value of these services to society.

The fundamental needs of banking customers are also unchanged. Individuals and organizations need bank accounts and services that enable them to safely hold cash and make transactions. They need access to credit — in forms ranging from microcredit to massive

corporate loans — to enable investment and economic advancement. Individuals, businesses, and institutions need to protect themselves against a range of risks that could not be borne at either an individual or an organizational level. Customers need savings and wealth creation vehicles in which to invest their money. And they need periodic advice on their financial situation and on appropriate products and services.

Finally, the core organizational capabilities that banks rely on as they pursue their purpose and meet customers' needs are still the same.

What, then, is different? The environment in which banks operate and compete. Three of the world's largest retail banks are now Chinese state-owned enterprises. Six of the 20 largest banks are new to the top order. Nine are based in the Asia/Pacific region, including two

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Australian banks and HSBC Group (whose CEO, Michael Geoghegan, is moving from London to Hong Kong). (See Exhibit 1.) Stand-alone investment banks, which formerly dominated much of the sector, have all but disappeared. Consolidation is creating high levels of concentration in the banking industry; witness JPMorgan Chase's takeover of Washington Mutual in the U.S., the acquisition of HBOS by Lloyds in the U.K., and Westpac's merger with St. George Bank in Australia. The ranks of the truly global retail banks are thinning, as yesterday's titans (such as the Royal Bank of Scotland, Bank of America, and Citigroup) retreat to the security of their home markets and capital bases, and as domestic banks merge, disappear, or narrow the focus of their businesses. The level of government regulation and ownership in the sector has risen dramatically.

The banking industry will almost certainly have to adjust to continued low growth — in its own revenues and in the broader economy. Its business models are being altered. The value propositions of seemingly timeless models in mortgage brokerage and insurance, private banking, securitization, and even financial advice are being questioned. The independence and relevance of the institutions that support confidence in the banking sector — rating agencies, credit bureaus, and regulators — have been compromised. Sovereign risk (the danger that a government will be unable to meet its financial obligations) has become a component of risk management at some banks, because they now function only with the support of their home governments.

Finally, the public trust on which banks and bankers depend has eroded. This trend has been exacerbated recently as some of the banks that received U.S. and U.K. public bailout money have gone on to reap

record profits, and some have continued to pay massive bonuses to their staff. Besides the visible populist reaction against this in many countries, there is also a serious decline in the credibility of the banking profession among long-term investors, pension fund and endowment managers, and large depositors.

As banks attempt to survive and prosper under these circumstances, their leaders can neither conduct business as usual nor adopt short-term fixes and half measures. The most successful banks will respond at a more holistic level, changing the way they operate. And as they do, and as their business models shift, the very nature of business will change for those sectors and individuals that depend on banks for security, stability, growth, and capital. Which is to say, everybody.

The industry is most affected in three broad areas:

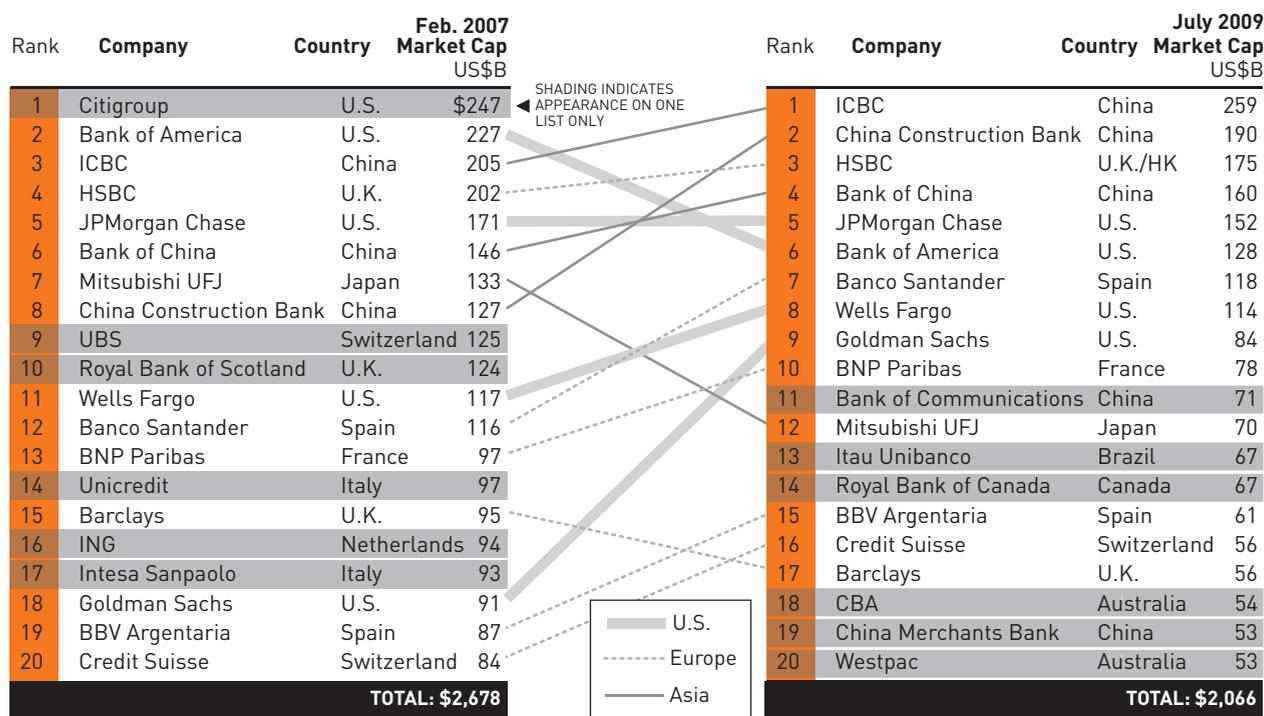
- The role of government is growing around the world, as evidenced by increased regulation and even outright ownership of the financial-services sector.
- Banks urgently need to regain their traditional closeness to customers. Even before the crisis began, the banking value chain had been fractured. In the pursuit of returns, banks enmeshed themselves in a complex web of intermediaries and new financial instruments. But the returns proved unsustainable, and now the old focus on customer relationships is returning.
- As growth slackens, it will affect the ways that banks compete and capture value. This has important implications for the nature and availability of banking services, such as loans, in the future.

**Utility-style Regulation**

The magnitude of the government response to the financial crisis will have fundamental and long-lasting

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Exhibit 1: The World's Leading Banks, before and after the Crisis



Source: Booz & Company

effects on banks everywhere. In the short term, governments have been forced to bail out insolvent institutions, supplying liquidity and guaranteeing obligations so these banks can survive. Many Western governments have taken ownership stakes in banks, and they will seek to exit these investments in an orderly manner, with a reasonable return. So far, at least, there is reason to think they will succeed.

However, a much broader debate with more endur-

ing consequences is occurring as governing officials rethink the long-term regulatory framework for this sector. It is highly likely that, by 2011 or so, the regulatory landscape in banking will more closely resemble that of public utilities. Like a water or electric power company, a bank will be seen as an entity that provides society with a product or service so essential that its delivery cannot be left to market forces alone. Utilities tend to face a high regulatory burden, which dictates many elements

## There could be a war for talent between private-sector and public-sector financial institutions, similar to the competition for health-care and education professionals.

of their pricing and operations, and often inhibits their levels of innovation and experimentation.

In many countries, the regulatory pendulum in banking had swung away from this model and toward free markets during the 30 years prior to the crisis. Many banks had been partially or completely deregulated during this time. They gained greater efficiency, enhanced their ability to attract and retain management talent, and enjoyed greater access to global capital for funding innovation and growth. But now, five driving forces are causing the pendulum to swing back.

**1. The growing perception of banking as a public good.** The crisis reinforced the idea that a steady flow of credit and a stable banking sector are as important to a productive economy as abundant resources, physical infrastructure, and human capital.

**2. The recognition that markets are not always efficient.** For decades, the prevailing logic of economics has maintained that market forces can best connect the sources and users of capital — with the resulting price accurately reflecting all available information. Now the realization is growing that people, and markets, can and do behave irrationally, and that these “animal spirits,” as John Maynard Keynes famously called them, can dramatically skew market behavior.

**3. The rising levels of systemic risk.** The increasing interconnectedness of the global financial economy has introduced new points of failure. Portfolio choices or product offerings that make sense at the level of a single business unit or small institution may trigger problems at the level of a large bank, a national economy, or a global financial system.

**4. The realization that “too big to fail” is simply too big.** The consequences of failure among key banking

players are causing policymakers to reappraise the need for government control over the size and scope of the largest banks.

**5. The broader consequences of misaligned compensation and risk management structures.** Existing pay and bonus models, in both the size and the design of their incentives, encouraged outsized risks by bank employees. Employees enjoyed the reward, but left shareholders, and ultimately governments, responsible for the downside.

The extent to and speed with which banking regulation will address these issues will vary from one nation to the next, depending in part on the strength of local banking systems, the broader economic outlook, and the market philosophy that holds sway within each government. But in general, state ownership and regulation will rise. Government owners will tend to favor activities within national boundaries, thus constraining global aspirations. They may break up banks, and recombine the pieces, to create single-purpose utilities. They may set up their own providers of basic services, such as low-cost banking and savings; they may increase loan portfolio requirements. They may also siphon off cash flow in the form of dividends to the state, thereby limiting investment options and potentially stifling innovation. These government owners will almost certainly demand a greater focus on forensic reporting, particularly in areas of public interest such as economic stability or in areas related to a political agenda such as health care. And there could well be a war for talent between private-sector and public-sector financial institutions, similar to the competition for health-care and education professionals in most developed economies.

On the regulatory side, we will probably see the

return of a Glass-Steagall-style separation of the industry, into retail banks, investment banks, insurance companies, and wealth-oriented businesses. Financial-sector mergers will be more closely monitored to maintain competition and avoid more too big to fail (or “too complex to fail”) episodes. Australia’s “four pillars” policy, which has prohibited mergers among the country’s four biggest banks since 1990, is likely to be a model. Regulators might set prices for critical products such as low-cost transaction banking, basic credit, retirement savings and pensions, life insurance, and health savings accounts; they will probably calculate minimum capital requirements in more sophisticated ways, linked to economic cycles, the fluctuating risk appetites among banks, and compensation models. There will be more comprehensive and onerous reporting requirements and a general demand for transparency and longer-term incentives, particularly in compensation models, to limit risk exposure.

Much debate is taking place about the individual measures and how effective they will be at averting future crises, but the overall trend toward greater regulation is inevitable. Most importantly, if banks do not or cannot fulfill their larger societal purposes, governments will stay involved longer with an even heavier hand. This could result in greater stability in the short term, but a less global, less innovative, and less talented financial sector over time.

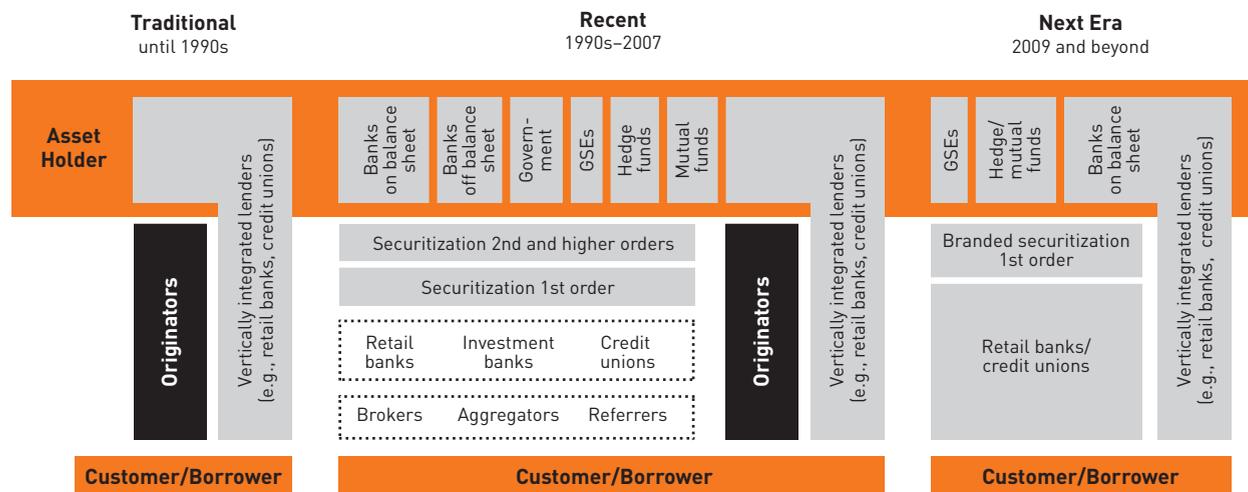
### Back to a Simpler Value Chain

The banking value chain was once a simple, clear flow of products and services, with typically only a single bank (and, at most, one intermediary) between the investors who held capital assets (the ultimate lenders) and the consumers or businesses who borrowed money and used other services. Then, starting in the early 1990s, the banking value chain was gradually altered at both ends. (See Exhibit 2.) Bit by bit, banks relinquished their direct customer connections (and the resulting information flow) to a host of new, smaller businesses, including brokers, aggregators, and referrers. At the same time, banks began packaging their loans into securities and selling them to investors, who saw them as a new — and high-yield — asset class.

At the time, there were compelling reasons for fragmenting this value chain. Innovative financial products, which broke up securities into tranches according to risk and return, allowed investors to choose among levels of risk and be compensated accordingly, at least in theory. A new “originate-to-distribute” lending model, emerging in the 1990s, rewarded banks and their third-party originators for the volume, not the quality, of loans. At the same time, new accounting rules allowed “shadow” assets to be hidden off balance sheets. This further facilitated the shift from a long-term, balance-sheet-management approach focused on maximizing the return on assets to a short-term, earnings-driven

Exhibit 2: Cyclical Changes in the Banking Value Chain

Before the 1990s, banks were the primary customer interface in a relatively simple lending system (at left). Then, as they packaged and sold loans to investors, and relinquished the customer interface to intermediaries, the banking value chain became much more complicated (center). The next value chain (at right) retains some innovations, but marks a return to simplicity and a new emphasis on customer relations.



Source: Booz & Company

approach that maximized return on borrowed capital. With all these incentives in place, it should come as no surprise that many banks focused on reaching more borrowers, became less concerned about underlying asset quality, increased their financial leverage to unrealistic levels, and encouraged more intermediaries to join in selling more products.

The unbundled value chain might still have been sustainable if investors had been able to accurately gauge the quality of the loan packages and other assets they bought. Unfortunately, rating agencies were paid by the same institutions that issued these securitized assets and, in some cases, actually worked with them to produce the numbers needed to reach the desired rating outcomes. As this played out, and as financial-services products became more complex and difficult to analyze, the effectiveness of credit ratings was quietly compromised.

The crisis has forced bankers to recognize that as they shifted the ownership of their loans — and the customer relationships those loans represented — to others, they reduced the transparency of their practices and increased their risk. To reverse the situation as global financial markets decrease their leverage, banks will have to reevaluate and redesign their value chains. They will return to more vertically integrated management systems, bringing their underlying assets and their customer-oriented capabilities back under tighter control. They must particularly focus on getting closer to their customers.

### Living in a Low-growth Environment

A rising tide lifts all boats, it is said. And few exceptions appeared in global banking between 2001 and 2007. Many banks took advantage of favorable margins and thin capital buffers to set new hurdle rates: Only those products with 20 percent return on equity or more were acceptable. To provide returns to their own shareholders, they relied on a simple formula: Increase cash earnings by 10 to 12 percent annually by growing revenues in the high single digits and keeping cost increases in the low single digits; use high dividend payouts to add another few percentage points; and exploit their own continually rising price-to-earnings (P/E)

ratios to offset low margins and the cost of capital in the banking sector.

This formula will no longer work, for several reasons. First, a quick economic rebound is unlikely. The current slump has already cut deeper and lasted longer than any recession to hit the U.S. economy since the Great Depression. It continues to affect consumer buying patterns around the world. Beyond the standard boom-and-bust cycle, this crisis is underpinned by fundamental structural imbalances that will take years, even decades, to work through, such as the U.S.–China trade deficit, the mismatches in growth rates among nations that have adopted the euro (the “euro zone”), the size and likely duration of the U.S. budget deficit, and the disparity between personal saving rates in Western and Asian economies. Even under the best scenarios for economic recovery, with speculation curtailed, asset growth in the financial sector will be significantly subdued.

A second reason banks must change their approach: They will have to keep a tight lid on expenses just to maintain their margins. And cutting costs will not be easy for them. The need to comply with increasing regulatory demands and to invest in a significant refocusing of capabilities — both of which are prerequisites for operating in the post-crisis environment — will create upward cost pressures.

Third, the price-to-earnings ratios for banks, which have often influenced share prices and thus financial incentives in the past, will languish. Banks can no longer afford to pay out large amounts of cash as high dividends to attract investors. In addition, P/E ratios are likely to reflect an expectation of lower risk and return over the medium to long term.

To see how conditions like these have played out in the past, it is worth revisiting the last major recession, that of the early 1990s, and the asset clearing period that followed. Margins initially widened as banks were able to pick and choose customers and dictate loan terms. Profit growth was generated mainly by working out bad debts. But margins soon shrank and the burden for generating growth shifted back to cost reduction.

The early signs from the current recession suggest that a similar pattern is developing. In mid-2009, mar-

gins began widening as nonbank and foreign competitors exited markets and the remaining banks used this opportunity to reprice lending, especially in their loans to businesses. However, by September 2009, it was clear that this would provide only temporary relief. Competition is increasing as stronger players use this opportunity to reposition and enhance their market share, and in the medium term, securitization and non-bank lenders will reemerge, driving renewed competition and, with it, continued margin compression.

### Building a Better Bank

These developments do not change the core capabilities required for banking success, but they require that those capabilities be retooled to better respond to the demands of the post-crisis environment. (See Exhibit 3.) Distinct improvements will be required for banks in a variety of domains.

#### Stakeholder management and investor relations.

The need to be more proactive in dealing with governments and to provide more transparent and relevant information to others will require improvements in stakeholder and investor relations management capabilities. Banks will need to explain how they can fulfill the fundamental social roles of the banking sector; they will need to engage in the debate over optimal regulation, and in its development, to help establish a robust and sustainable industry.

To do this, banks will need to show that they understand the needs and objectives of public officials, particularly the need for systemic stability. They will be called on to help achieve those goals and to demonstrate the progress they have made toward restoring confidence and stability, particularly in the areas of com-

pensation and risk management. The recent and very public efforts of some banks, such as Commonwealth Bank of Australia and Deutsche Bank in Germany, to cut executive salaries and reduce exception fees (consumer charges such as overdraft and late payment fees) represent a good example of this approach.

**Performance management.** Regardless of the regulation and government ownership that arises from the crisis, banks must be prepared to respond to demands for

Exhibit 3: The Impact of Economic Changes on Banking Capabilities

MACRO DEVELOPMENTS	CAPABILITIES AFFECTED
Utility-like regulation of banking	<ul style="list-style-type: none"> <li>• Stakeholder management and investor relations</li> <li>• Performance management</li> </ul>
Banks reassert ownership of their assets	<ul style="list-style-type: none"> <li>• Customer management</li> <li>• Risk management</li> <li>• Distribution management</li> </ul>
New lens on value in a low-growth environment	<ul style="list-style-type: none"> <li>• Product and offer development</li> <li>• Operations and information technology</li> <li>• Asset and liability management</li> <li>• Capital management and portfolio strategy</li> <li>• Talent management</li> </ul>

Source: Booz & Company

much greater transparency from all their stakeholders — including investors, governments, customers, and communities. No longer can metrics be focused solely on short-term financials, such as profit growth, cost-to-income performance, and dividend payout ratios. They must expand to include longer-term measures that offer insight into funding durations, loan-to-deposit ratios, and capital management through the full course of an economic cycle. Banks will be asked to show their contribution to the stability of the larger financial system, reporting in greater detail on credit liquidity, the balance of assets and liabilities, and the safety of savings. And they will need to demonstrate strong ongoing institutional financial performance.

**Customer management.** Bankers have been reminded that their core asset is their customer base, both individual customers and businesses. Like successful businesses in most other industries, the leading banks are sharpening their capability for capturing customer information in a timely manner. For banks, this means analyzing their customers' product holdings, cash flows, behaviors, and personal circumstances. Depth of relationship will be more important than breadth. It will be more valuable for a bank to have an 80 percent wallet share of 1 million customers than a 10 percent share of 8 million customers. Greater wallet share permits greater insight into buying patterns, credit risk, and loyalty, enabling a stronger, more profitable lifelong customer relationship. For their part, customers will find that scarce credit lines are more accessible when they concentrate their banking activities among fewer providers.

**Risk management.** Both the effectiveness and the efficiency of risk processes must be improved. To enhance effectiveness, banks must price accurately for

risk and make full use of the improved information flow that results from retaining more direct ownership of their assets. They will need to regularly review risk management approaches within the different parts of their portfolios, and to complement external ratings (by agencies such as Moody's and Standard & Poor's) with their own more robust internal analyses. This will yield other benefits: It will broaden the base of information available to banks, and it will minimize their reliance on the narrow and potentially skewed analysis that resides at centralized credit bureaus.

Unemployment and poor stock market performance will continue to increase the inherent riskiness of many consumer loans. Banks will need to augment their current statistically based methods for assessing risk for consumer loans with the more sophisticated use of customer behavior information. As some banks learn to cherry-pick low-risk loan customers, broader approaches, such as community-rated pricing (in which all customers are charged the same premiums), will prove less competitive.

To enhance efficiency, many banks will revisit the way they process credit applications, adopting abbreviated or short-form processes only for existing customers or for refinancing, and applying a more complete analysis to higher-risk or more uncertain prospects.

**Distribution management.** Banks need to place less emphasis on third-party intermediaries such as brokers, aggregators, and referrers. Instead, they should refocus on establishing and developing their own channels to customers. With these in-house channels, banks will become more sophisticated in defining and targeting customer segments, designing differentiated customer experiences that align with their brands, and delivering

## In the post-crisis era, customers will concentrate their business, favoring banks they perceive as stable, secure, and able to provide the products and services they require.

value across an integrated suite of programs and products. For example, HSBC has created a high-touch customer experience for its “premier” clients in Hong Kong. These high-net-worth customers receive preferential counter service and pricing, supported by a branch upgrade that allows tellers to spend more time on service and less on routine transactions, plus a 24-hour call center and website that provide an integrated view of both local and foreign currency accounts.

Among universal banks, in-house channels for investors will replace intermediaries, especially for complex financial instruments. Banks will also need to reevaluate how they move loans off their balance sheet through securitization. The basic practice will continue, because its essential premise remains sound. It provides an effective means of funding and managing lenders’ balance sheets, and it provides investors with risk and return profiles tailored to their needs. It is highly unlikely, however, that second- and third-order securitizations (in which tranches are recombined and repackaged several times) will return, given the lack of transparency and unsustainable leverage they engendered. Instead, investors will conduct their own due diligence, demanding clear transparency into asset quality and first-order relationships with lenders. Banks that brand themselves as providing superior reporting on the quality of their assets will command strong relationships with investors and maintain an edge over resurgent nonbank lenders. They may even be able to develop and market branded securitizations, in which the integrity of the originating institution becomes a key selling point to investors.

**Product and offer development.** In the post-crisis era, customers will concentrate their business, favoring banks they perceive as stable, secure, and able to provide

the products and services they require. To win these customers, and the greater wallet share they represent, banks will increase their efforts to meet a full range of customer needs. They will offer services such as cash-flow management (especially as customers face changing personal situations and budgets) and new forms of financial advice, likely with a greater focus on transactional support. Bancassurance (the selling of insurance through a bank’s existing channels) represents another critical opportunity; with the destruction of wealth in stock markets and other investment channels over the last year, banks can expect to see a strong and growing demand for mortgage protection, income protection, life insurance, and health savings accounts.

**Operations and information technology.** Many banks have had difficulty reducing costs enough to compensate for shrinking margins. In the past, expense reductions have tended to come from two sources. The first is process improvements aligned with individual products; this approach is now at odds with the need for greater customer-centricity. The second source is offshoring and outsourcing, which will become less acceptable in a climate of greater government oversight. In fact, some bank chief executives, such as Gail Kelly of Westpac in Australia, have publicly ruled out offshoring in an effort to improve their battered corporate reputations and brands.

Numerous banks will thus seek to develop better operational and IT management capabilities to cut costs. This represents a major opportunity for them: They can reinvent their systems architectures, replace core mainframes that date back to the 1970s or earlier, and realign the structure of the business around customer needs. A clear differentiation will likely emerge

## The recent dramatic rise in savings rates in Europe and North America represents a major opportunity for banks to shore up a critical gap in their customer offerings.

between the banks that have the resources and drive to take this opportunity and those that don't.

**Asset and liability management.** Easy access to low-cost wholesale capital during the pre-crisis era caused many banks to lose sight of the role of deposits as a critical source of funding. Too often, deposits were managed in a fragmented manner across multiple lines of business. Now, however, banks must manage their cash holistically. The banks that do this well will have a distinct advantage, and some will emerge as aggressors in M&A deals.

The recent dramatic rise in saving rates in Europe and North America represents another major opportunity for banks to shore up a critical gap in their customer offerings while more proactively managing a core element of their funding mix. Capturing these new deposits will require banks to apply a level of sophistication to product innovation, pricing, and customer analytics that was previously applied only to the lending side.

**Capital management and portfolio strategy.** Capital is now acknowledged as a critical strategic asset and needs to be managed as such. A restricted flow of capital destroyed institutions such as Bear Stearns and Lehman Brothers, whereas more savvy stewards of capital, such as JPMorgan Chase and Goldman Sachs, are emerging from the crisis as clear winners.

But it won't be enough to manage capital strategically. To securely fund business growth in the coming era, banks will have to diversify their funding base. For debt, this will mean diversifying duration; in fact, regulators in some countries are already moving to mandate longer-term requirements. For equity, it will mean thinking ahead about alternative sources of capital, including strategic investors and sovereign wealth

funds, before they are needed.

Banks must also effectively communicate their strategy to investors, particularly as they seek to expand. Big is not necessarily beautiful anymore; shareholders will no longer tolerate empire building for its own sake. They will expect to see a compelling business case for each M&A deal, as well as subsequent reporting on a deal's performance.

At the same time, as noted earlier, the old promise of low risk and high return has proven illusory. Shareholders in many countries are now presented with a less attractive, although possibly more sustainable, opportunity: low risk, low return, low volatility. Banks need to set this expectation as part of their branding and manage it actively.

**Talent management.** The last decade of banking has seen an increase in hiring from outside the financial-services sector, focused on functional skills like marketing that were thought to be transferable. Today, banks need more comprehensive industry-related expertise; a single executive might need to be fluent in customer analytics, asset and liability management, distribution, products, and operations. This highlights the value of a more traditional rotation model, in which well-rounded, high-potential bankers are groomed for senior leadership by being asked to serve in multiple functions during their careers. And it reinforces a shift that is already under way, from talent recruitment to talent retention and development.

Important cultural changes will also be required in the aftermath of the current crisis. The need for a holistic view requires effective teaming at senior levels and the elimination of the "cult of the leader" phenomenon that creates barriers to collaborative management. As

banks become more outwardly focused, they will also need people who can understand customers more easily, and who can work with regulators, investors, and communities in a more inclusive way.

### Why Banks Still Matter

Banks — whether government controlled or privately held, whether specialist, regional, or universal players — are still the heart of the global economy. They pump the funds on which productive human enterprise depends. Banks *must* perform this role well, with all the diligence we would expect of any expert or custodian of an essential task.

Banking organizations must refocus on those fundamentals that are unchanged by the financial crisis — their core purpose, customer needs, and capabilities — while recognizing that profound market changes have occurred and will affect how these capabilities need to be delivered. Those leaders whose banks can respond to the times and enhance their capabilities will be tomorrow's winners.

As customers of banks, we must recognize that this sort of trust and long-term relationship is in our best interest. It will allow us to share information and make better decisions, and it will also give us greater access to scarce credit liquidity.

As investors in banks and bank securities, we may have to accept lower returns as a trade-off for greater transparency, greater security, and a form of economic growth that reliably, if more slowly, does a better job of lifting all boats.

As citizens, and as the regulators of banks, we need to make sure that the core purpose of the financial-services industry is fulfilled. The capital security of indi-

vidual institutions must be guaranteed, and the risks of the overall system must be managed. We must continue to encourage innovation, best practices, access to global capital, and the best talent. Banks need all these elements to function, and functioning banks are indeed critical to the recovery and prosperity of our nations. +

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