McKinsey on **Banking**

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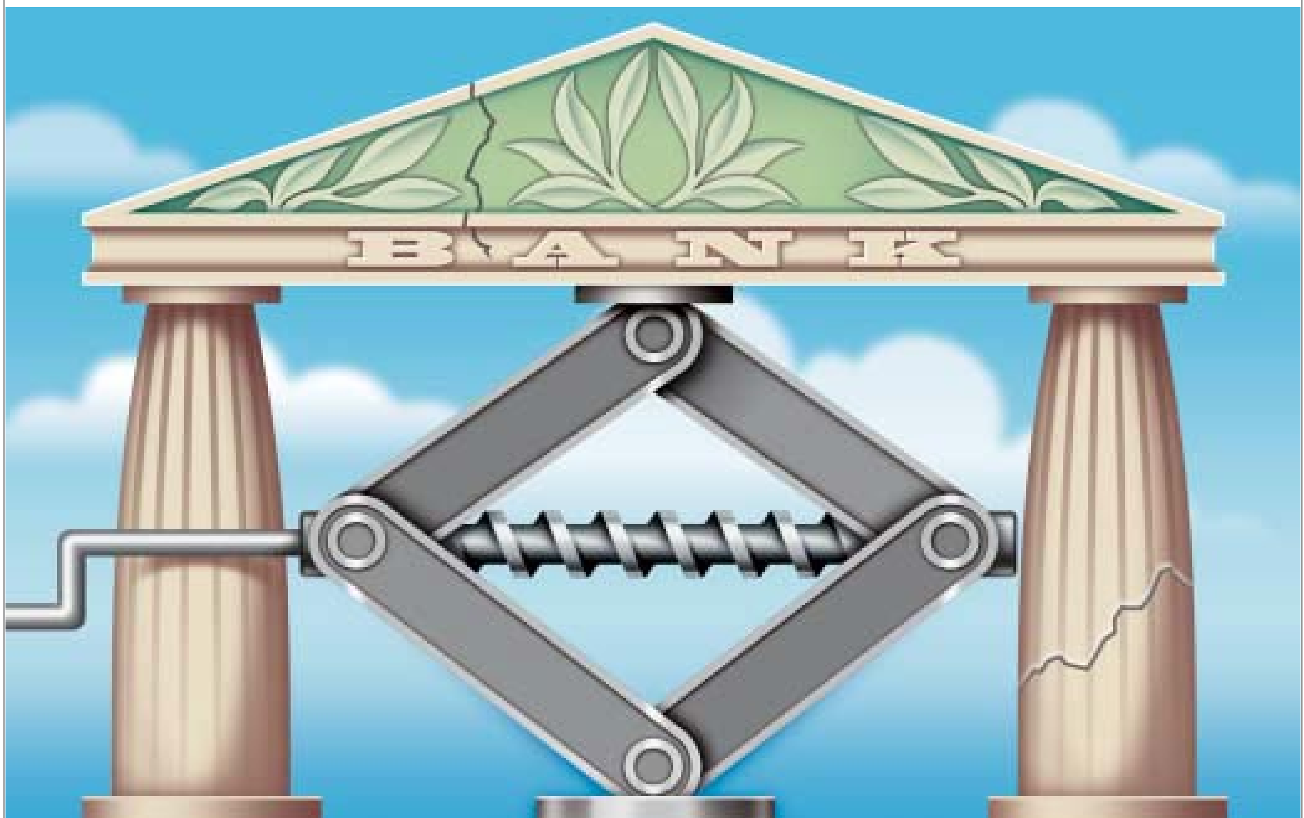

Lloyd Miller

Pursuing **best practice** in bank turnarounds

Failing banks must overhaul their management and focus on the bottom line if they hope to get back on track.

Article at a glance: Financial crises are inevitable, but bank closures are not. When a crisis strikes, careful attention to the liquidity of a bank—and, if necessary, the assistance of a central bank—can prevent it from failing. Whether the crisis was the result of poor management or of macroeconomic conditions, a successful turnaround depends on using well-known but frequently ignored management skills to restore confidence as conditions improve.

The take-away: The formula for a successful turnaround is straightforward and similar around the world: monitor liquidity, rein in bad lending practices, and find creative ways to add fresh capital.

Pursuing **best practice** in bank turnarounds

Dominic Barton, Roberto Newell, and Gregory Wilson

Economic recovery is under way at last in some emerging markets, but distressed banks are still all too common in Asia, Eastern Europe, and Latin America. During this turbulent time, however, some bankers and governments in these regions have accumulated valuable experience about managing the short- and long-term restructuring of financial institutions. Best practices for successful turnarounds have emerged and hold important lessons not only for bankers in other markets but also for governments, which too often play a stewardship role for which they are unprepared.

Successful turnarounds involve neither exotic formulas nor financial magic. Instead, management must undertake actions that appear to be obvious but are frequently ignored or resisted. Such a program usually requires banks to bring in a new management team, for example, but incumbent executives in many emerging markets are often socially or politically well connected and can thus retain their positions. A successful turnaround includes both operating improvements and a focus on the bottom line. We have worked in some markets where executives and the government thought that simply hanging on was good enough—an attitude that can prolong the agony of a troubled bank without resolving the underlying problems. During a multiyear change program, a management team might confront hundreds of options. Yet in our work with ailing banks, we found three broad areas that are critical to their survival after a financial crisis: managing liquidity, reducing the number of high-risk loans, and adding fresh capital.

Manage the bank's liquidity

Maintaining liquidity during a crisis gives a bank time to concentrate on its next steps without worrying about a government takeover—but that's easier said than done. During the first days of a banking crisis, domestic depositors line up to get their money back. Meanwhile, volatile foreign-exchange and interest-rate markets, which frequently accompany banking crises, vastly complicate liquidity management. Wrong guesses are costly and often fatal because many banks in emerging markets lack a fundamental understanding of the necessity of liquidity.[1] A deep knowledge of what funds are leaving the bank (and what funds, if any, are coming in) and of the mismatches between interest and exchange rates is critical to sustaining liquidity during and immediately following a crisis.

During the crisis

When liquidity drains from an institution during a crisis, there's only one place to go for relief: the country's central bank. For this reason, close collaboration between the central bank and illiquid but solvent banks is vital. When cooperation between the banks and the government breaks down, as it did in Argentina in 2001, banks have to face the disintegrating situation alone. After the Argentine government made a series of decisions that all but destroyed public confidence—a currency devaluation, a freeze on consumer deposits, and a series of bank holidays—the entire banking system nearly collapsed. Conversely, a solid relationship between the public and private sectors during the financial crises in Malaysia and South Korea helped keep banks afloat and allowed them to emerge in relatively good shape. Depositors had enough confidence to leave their money in financial institutions, which were able to operate throughout the crisis. During the economic recovery, bank executives and regulators communicated constantly, and all parties understood that working together was best for the system and their shared interests.

In recovering or unstable financial markets, banks and governments can cause full-blown crises by working at cross-purposes. We observed one Latin American country where both a large institution and the government, which plays a pivotal role in any country's money and currency markets, tried to raise money without coordination. Interest rates spiked and investors panicked, leading to rapid cash withdrawals and a renewed run against the local currency. In effect, the bank and the government were crowding each other out of the markets—a state of affairs that can

[1] Brazil and Venezuela are exceptions. When crises are fresh in the bankers' memories, the importance of liquidity is generally understood.

confuse investors and depositors alike and make a deteriorating situation worse. Following this incident, the government agreed to cooperate more closely with the banking industry.

And afterward

Once the crisis passes, CFOs and treasurers of banks should focus on three steps.

Restoring access to liquidity. In a banking crisis, sources of cash dry up; the central bank provides funds temporarily or not at all. With a return to relative normality, bankers must restore credit lines with domestic and foreign correspondent banks. Given the damage to both the country's and the bank's image, this effort can take a long time.

Managing ongoing liquidity conditions. CFOs should also hold more frequent asset and liability reviews as part of this new approach. These meetings help a bank to anticipate its liquidity requirements, to ensure that assets match liabilities, and to verify that the line officers—whose responsibilities include investing in government bonds and making new loans—recognize the bank's needs and the potential impact of large withdrawals.

Maximizing available cash. Such measures as repricing products, resetting interest rates, and renegotiating reserve positions with the central bank can generate more cash to bolster a bank's liquidity. A bank must carefully monitor its discretionary spending and cash disbursements to ensure that it meets its liquidity requirements. Bankers can, for example, delay spending on projects with long-term returns and on IT systems, advertising, and other discretionary items. But we have yet to see a turnaround that didn't require big personnel cuts, a reduction in cash disbursements (including salaries and bonuses), and a significantly smaller scope of operation to stabilize the bank and position it for new growth.

In 1998, the year following South Korea's economic crisis, more than 30 percent of the country's banking employees lost their jobs. Similarly, the new CEO and chairman of Kookmin Bank[2] was forced to lay off 30 percent of the workforce in the first three months of his tenure—a previously unheard-of course of action in South Korea.[3]

Stop making risky new loans

Officers who booked their institution's bad loans shouldn't make decisions on new ones without a wholesale revamping of its credit- and risk-management processes. This overhaul usually means canceling all unused credit lines, examining every loan on the books and determining its relative value against the current market, centralizing credit decisions, and suspending loan rollovers until it is possible to conduct a rigorous review, including scenario planning. Ultimately, a whole new credit- and risk-management system must be imposed.

We have seen firsthand the damage poorly supervised loan officers can cause. Workers Bank of Jamaica, for instance, continued to make unprofitable loans even after it was taken over by the government. So did a large Latin American bank, which offered new loans to relatives and favored customers before analyzing the risk-reward trade-offs and pricing loans accordingly. In 1999 this bank failed—not surprising given the oversight by the government's new, untested, and understaffed deposit-guarantee agency. After injecting roughly $800 million in government bonds, it installed new management but did little else to oversee the bank's rehabilitation.

From the time the new management arrived until the bank's failure, no attempt was made to manage and collect nonperforming loans, sell bad assets, improve lending skills, or impose new risk-reward processes and metrics. Since there was no investment contract between the bank and the agency, no management incentives were in place to support a successful turnaround effort. The bank continued to make loans to unreliable borrowers in the same way that had contributed to its initial downfall. It even took the agency's bonds, sold them on the secondary market, and used the proceeds to go on lending as it had before its takeover.

Analyzing the lending practices of a failing bank may bring some unpleasant surprises to the surface. We advised a

[2] Formerly Housing & Commercial Bank of Korea.
[3] Dominic Barton and Jaehong Park, "Asia's banking maverick," *The McKinsey Quarterly*, 2003 Number 1, pp. 108–19 (www.mckinseyquarterly.com/links/12899).

Mexican bank, for example, to cancel its credit lines and call in its short-term loans. In this way, the bank could gauge the health of its evergreen portfolio (its long-term, low-risk assets and liabilities) and track profits from some parts of its short-term portfolio. The study revealed that a significant proportion of the loan portfolio's value was impaired and would never be recovered fully. In addition, the bank's short-term loan operations were in part actually funding fixed assets and other nonliquid investments.

Although many of the bank's loans had to be restructured, it finally learned the actual extent of the problems. Determining the true value of the loan portfolio forced the bank to create reserves and to reprice many of its lending products. Management focused on the right credit issues and kicked off a loan-recovery process that might have taken longer to start if these measures had not been implemented. Drastic action made the bank the very first in the country both to recognize its problems and to clean up its nonperforming loans. By moving fast, it improved the conditions of its loan portfolio and minimized write-offs.

Unfortunately, many countries lack not only adequate bankruptcy laws but also proper courts and procedures to adjudicate defaults. The absence of a channel to resolve delinquent accounts actually prevents rapid loan workouts and thus the return of productive assets to the economy. In countries where legal systems can't cope with the complexities of a financial crisis, it is possible to avoid lengthy delays and any resulting effect on the economy by undertaking loan and asset workouts—settlements between creditors and debtors that are negotiated outside a problematic legal framework. Even in developed markets, legal systems often hinder banks in the midst of a restructuring from fully recovering their bad loans.[4] In almost every bank turnaround, recovering debt from the nonperforming-loan portfolio has proved to be the most important way to improve profits.[5] If reserves have already been taken on these loans, the assets recovered drop straight to the profits column, thereby shoring up the capital base of the bank and restoring its ability to book fresh loans. Even when this isn't the case, bank managers should act as if all loans were impaired, if only to reflect the fact that in turbulent times the value of collateral may fall.

For this reason, banks should immediately review their customers' payment status and consider action—such as renegotiating conditions or payment terms and agreeing on mutually beneficial workout plans—to prevent loans from going bad. These measures will not only protect the loan portfolio but also, perhaps, increase the bank's value relative to that of its competitors. Although banks in crisis may not return to lending for some time, they need to reevaluate their strategies and redesign their loan-approval processes to prepare for the day when they do. Institutions also need to ensure that appropriate rating systems and review processes are in place, since a marked improvement in credit skills should be a top priority before new lending can begin.

Add new capital

Banks can begin raising fresh capital as soon as they can tell a credible turnaround story to regain the trust of investors and the government. Combined with new credit skills, an influx of capital is critical to restart lending and earnings growth.

Kookmin Bank, for instance, became South Korea's leading retail institution just five years after the start of that country's banking crisis, in part by making the infusion of private capital an important part of its strategy. The new leadership of the bank differentiated it from most other domestic competitors by improving its risk-management skills and pursuing corporate-governance reforms, among other initiatives. As a result, the former Housing & Commercial Bank (H&CB) attracted new capital from foreign banks. (One of them, the Dutch bank ING, purchased roughly 9 percent of H&CB, got a board seat in exchange, and helped the bank develop new credit- and risk-management skills, which gave it a competitive advantage over its slower-

[4] During the banking crisis of the late 1980s in Texas, for example, many large banking organizations, such as North Carolina National Bank, set up separate subsidiaries to manage loan workouts and bad-asset sales as an alternative to watching the value of their assets diminish while they waited for a court decision.

[5] For more on managing nonperforming loans, see Laurence W. Berger, George R. Nast, and Christian Raubach, "Fixing Asia's bad-debt mess," *The McKinsey Quarterly*, 2002 Number 4, pp. 138–49 (www.mckinseyquarterly.com/links/12901).

moving competition.) Despite recent problems with its credit card portfolio, Kookmin remains one of the most successful examples of a bank turnaround and transformation.

Systematic problems (such as cronyism in the loan-approval process and poor monitoring of cash positions) that go unchecked for years make it difficult for banks in some countries to attract new capital, thereby forcing them to rely on public funds for survival. Recently, China had to inject massive amounts of capital from both its central-bank reserves and its tax revenues to stabilize important banks systemically until fresh private capital could be obtained. Although a publicly funded asset-management company stepped in to save one large bank that was critical to the nation's struggling financial system, action of this type is only part of the solution. Chinese asset-management companies typically purchased bad assets from a failing bank, which received much-needed cash. But since the asset-management company, not the bank, collected these bad loans, Chinese banks weren't necessarily acquiring new and better risk-management skills.

Creating a "bad bank" can be an excellent way to sweep such assets from the books of restructuring banks and, at the same time, to generate capital (see sidebar, "'Bad banks' are good"). A bad bank is often staffed with employees from the parent company who likely would lose their jobs if nonperforming loans were sold to an asset-management company. Retaining experienced people for these positions keeps valuable knowledge about loan workouts in the bank, thereby providing continuity to the endeavor. Ultimately, banks must also acquire new workout and resolution skills. The bad-bank strategy requires the same level of leadership and commitment regardless of the setting—private or state-run banks, in developed or developing nations. By selling bad loans quickly in one lump sum, banks can raise fresh capital and return to profitability while management focuses on the core business strategy.

In analyzing our experiences with bank turnarounds, we have arrived at two major conclusions. First, the architecture of successful turnarounds throughout the world is very similar. The details may vary, but the fundamentals that drive these programs are surprisingly alike. Thus the lessons learned are generally applicable throughout the world. Second, the requirements for success are relatively straightforward; execution is the determining factor. Investors and management teams that recognize and embrace these lessons sooner rather than later are sure to see faster results and better returns for their customers and employees.

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'Bad banks' are good

Although Mellon Bank is a large institution in a developed market, many struggling banks in emerging markets can apply its turnaround model: isolate bad loans and maximize their recovery value over time, either before or after government intervention.

Mellon uncovered problems in its loan portfolio in 1987, two years before the US banking crisis began. For the new executive team at Mellon, finding cost savings and resetting the bank's strategy weren't sufficient. It was necessary to raise about $500 million in fresh equity capital—and fast.

Working with E. M. Warburg Pincus, a New York–based venture capital group, the team decided to tap into the junk bond market and to finance the creation of Grant Street National Bank (GSNB), known as a bad bank. The plan was to transfer roughly $1 billion—in book value only, for the market value was half that figure—of Mellon's nonperforming assets to this new subsidiary, using the proceeds of two common-stock offerings. The sale of stock netted $525 million, which offset the losses from the loans and other bad assets and injected new capital into Mellon.

This new entity was spun off to Mellon's existing shareholders, and a new class of stock was provided as incentive compensation for its directors. GSNB also entered into a management contract with another Mellon Bank subsidiary, Collection Services, to work out the bad loans on the basis of costs plus 3 percent of collections. This unit worked under the close direction of GSNB's management and had a staff of more than 50 people with strong workout skills.

A host of investment bankers, lawyers, and accountants worked for the venture, and by all accounts GSNB was a success. The well-structured subsidiary offered appropriate incentives to an experienced workout team, which went back to Mellon after its mission was complete. GSNB even returned its charter to the banking authorities ahead of schedule, retired its debt early, repaid the preferred stock held by Mellon, and gave essentially all of the common equity back to GSNB's shareholders. As an added benefit, the subsidiary provided Mellon's employees with a psychological lift: once the bulk of the problems had been separated from the remaining bank, a light suddenly appeared at the end of the long tunnel.