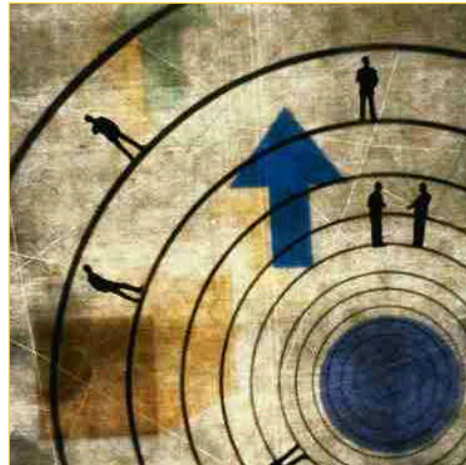

Managing Successful Bank Restructuring:
The Mellon Bank Story

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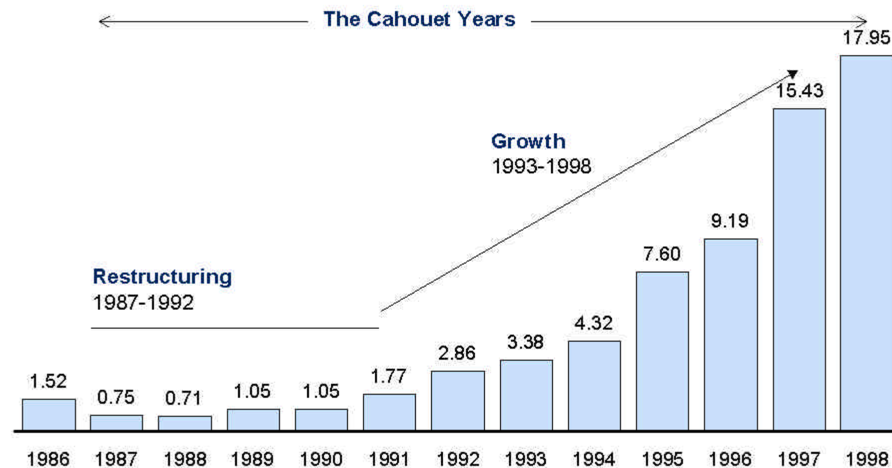
The need for bank restructuring is a fact of life today, both in the developed world – Japan, Germany, and even the United States, and in emerging markets – Argentina, China, India, Indonesia, the Middle East, and Turkey to name a few. Bank turnarounds are driven by a number of forces: fundamental regulatory reform (the U.S. in the 1990s); geo-political conflict (Iraq); financial crises (most of Asia, Russia); privatization of state-owned banks (many emerging markets); and investor demand for change and higher returns, often as a result of poor risk management resulting in significant nonperforming loans – the case of Mellon Bank. Every country needs strong banks to serve customers and support real economic growth. Thus, bank restructuring is here to stay.

The turnaround and restructuring of Mellon Bank in the late 1980s-early 1990s is one of the most successful examples in U.S. financial history, and it can serve as a classic case study for all bankers and investors anywhere in the world. These lessons can be applied to not just publicly traded banks but also state-owned banks, though there will be obvious differences in the bank's vision, governance, and capital structure.

This article profiles Mellon's success story, under the notable leadership of Chairman and CEO Frank V. Cahouet, his CFO Keith Smith, and their management team.[1] While all bank turnarounds and restructurings take years to complete, the rewards to all stakeholders – investors, customers, employees, and even regulators – can be enormous (see exhibit on following page). At the end of this article, Mr. Cahouet, now Chairman Emeritus, offers some direct and sound advice today for CEOs everywhere – in his own words.[2]

1 This article has been adapted from *Dangerous Markets: Managing in Financial Crises* by Dominic Barton, Robert Newel, and Gregory Wilson (New York: Wiley Finance, 2002.)

2 McKinsey interview, August 12, 2003, Pittsburgh, Pennsylvania.



MELLON BANK'S SUCCESSFUL RESTRUCTURING

The 5-year turnaround of U.S.-based Mellon Bank Corporation[3] is one of the most successful models anywhere in the world, and it provides managers with universal lessons that can be adapted and applied in any country.

Founded in 1869 in Pittsburgh, Pennsylvania, by retired Judge Thomas Mellon and his sons, Andrew and Richard, Mellon Bank had a distinguished and prosperous history for more than 100 years as a pillar of the U.S. financial landscape. By the mid-1980s, Mellon Bank had transformed itself into a growing money-center bank. It was the 15th-largest bank in the country, with a product reach that spanned not only the lucrative trust business and industrial financing in the Midwest, but also real estate and energy lending in the Southwest, and even extensive lending to less developed countries (LDCs).

3 Mellon Bank's parent holding company is now known as Mellon Financial Corporation.

In late 1986, however, Mellon Bank's board of directors began to be concerned about the rapid growth and concentration of the bank's credit portfolio in areas of the economy that were showing signs of strain. In the first quarter of 1987, Mellon Bank reported its first quarterly loss ever, with the board blaming the bank's rapid expansion program for this unprecedented loss. The bank posted a $65 million loss, made a $175 million provision for future loan losses, and cut its dividend to shareholders in half. At that time, the future of the bank looked bleak. It was time for the board to act. It fired the CEO and replaced him temporarily with a veteran board member until a search committee could find a permanent replacement to turn the bank around and save it from potential failure and takeover by the government.

By June 1987, Frank V. Cahouet, the former CEO of Crocker National Bank in California, was brought in to turn Mellon around. He was joined by W. Keith Smith as CFO, who held that position at Crocker, as well as Anthony Terracciano from Chase Manhattan Bank as president, a position he held until January 1990. Each of these managers had long, successful careers in banking in other U.S. institutions, and together they brought their collective turnaround expertise and experience to Mellon Bank. As they joined the bank, Mellon was about to announce a second quarter loss of roughly $566 million with a loan loss provision of $533 million. At the time, Mellon's market capitalization was roughly $750 million, and without fast action it was at risk of failing.

The leadership team had its most challenging times ahead of them and went to work immediately to revitalize the corporation and return it to profitability. Like talented jugglers, they had to keep three synchronized streams of work moving simultaneously to be successful: they had to stabilize the bank immediately and stop the bleeding from life-threatening credit losses and unsustainable expenses; they had to refocus the vision and strategy of the bank in a way that its internal and external stakeholders – employees, customers, creditors, investors, and regulators – could readily understand and support; and finally they had to recapitalize the bank, not simply to make provisions for the huge credit losses that were mounting but also to position Mellon appropriately to leverage its brand and other strengths for the competitive future.

Stabilizing the bank to stop the losses

The most immediate task was to stabilize the bank, stop the credit losses, and preserve its cash flow. The new team immediately saw problems that were similar to those at Crocker: destabilizing credit losses; excessive operating expenses with inadequate controls; a basic lack of focus on profitability and misunderstanding of what the numbers actually meant; a management team that was not prepared to recognize or trained to manage problems, especially problem credits. For example, they found that the controller knew more about the quality of the loan portfolio than the lending management, and much of the basic financial analysis presented to them when they arrived was only surface deep.

In July, one month later, they had a stabilization plan in place that consisted of a number of basic tools used to stop the hemorrhaging. They instituted a cost reduction program that would result in a layoff of roughly 15 percent of Mellon's workforce within 6 months to save on operating expenses. They renewed early retirement incentives for 300 employees. They continued to exit Mellon's international businesses, closing half of the bank's foreign offices while laying off 200 out of 700 employees by October. They moved quickly to empower people, encouraging employees to bring them fresh and novel ideas to save money and improve internal processes; this move forced the team to dig deep into minutiae at all levels of the bank's operations to find needed cost savings.

One award-winning idea came from a long-term employee who noticed that Mellon was consistently paying high fees to the local fire departments whenever the balloons they used to celebrate hitting sales targets in the branches set off the fire alarms when they rose to the ceiling. The employee's idea was to call the fire department ahead of time, tell them about the branch party and the balloons, and ask them not to send their trucks when the false alarm rang. While obviously a tiny savings compared to the magnitude of the bank's problems, they used this story successfully to convey two larger messages: first, every single idea – no matter how small – was needed; and second, for the first time, management was listening to the front line, and employees' ideas were being taken seriously as the senior executives probed everywhere for creative ways to rebuild the bank.

The new leaders set out to change the management group and culture as well. They organized their own immediate management team – former colleagues whom they trusted – and effectively did their own version of a hostile takeover of management, which helped to change both the players and the culture deeper in the company. They encouraged employees to raise problems sooner rather than later, something that had been a contributing cause of Mellon's credit problems in the past; they made it clear that they would not "shoot the messenger."

The new Cahouet team led by example, starting its days at 6:00 a.m., typically working 60-hour weeks. The entire top management team met twice a week, Mondays and Fridays, from 7:00 a.m. to 9:00 a.m. for three reasons: to ensure the necessary two-way communication throughout the bank at all levels; to eliminate the traditional territoriality among individual managers the next level down from the senior managers; and to rebuild a climate of trust and teamwork among the entire senior management team.

These experienced turnaround artists also recognized the value of being nimble and moving swiftly in a crisis situation. Together with other executive committee members, they made decisions quickly and didn't agonize over their decisions once made. To move at the speed needed, they also recognized that they would make some mistakes along the way, but that was part of their management process. As a team, they could fix mistakes later and learn at the same time.

To be successful, the senior management team had to have the full confidence of Mellon's board of directors as well as its regulators – and they did. They held monthly board meetings, relied heavily on a strong audit committee and process, and worked hard to ensure excellent communication with their board and major shareholders. "We wanted the board to cheer for us from the stands, and occasionally sit with us on the sidelines as we rolled out our game plan," Cahouet explains, "and that was appropriate, but we didn't suit them up and send them on the playing field – that was our job. They understood the difference between a governance role and an operating role."

They also began to reorganize the bank early to send the right message throughout the organization. From their perspective, there was no built-in resistance to their new strategy and operating style anywhere in the company that they could not control. They also brought in a new head of human resources, an individual with a strong industrial background, to help complete the transformation. Performance reviews were conducted three times a year to get their message across to all senior employees.

Part of their early efforts also focused on "educating many of our managers on the simple math of the banking business," according to Smith. They forced their managers to focus on bottom-line profitability, paying greater attention to margins and returns on invested capital while worrying less about hitting volume targets. They implemented monthly budget reviews, where the business unit managers had to explain and defend three sets of numbers: their original operating plan for the year, the actual monthly results, and their revised projections for the year. Management focused on the absolute numbers as well as the changes month-to-month. Mellon leveraged its existing technology with some modifications to enable business unit managers to be able to report net income and return on equity within a few days of the monthly closing of its books. All business units had their own finance officers, who reported directly to the CFO, to ensure that there was no gamesmanship with the numbers. If business unit managers reported an 8 percent ROE when their target was an 18 percent ROE, then they had a problem with management. As former and current CFOs, the senior management team understood numbers and imposed this rigorous financial discipline throughout the company.

Another key ingredient to the immediate task of stabilizing the bank was securing the cooperation of the bank's regulators, who could have taken almost total regulatory control in 1987. Thanks to the credibility that the team leaders had built with the various bank regulators in their past positions, the Federal Reserve (the regulator of Mellon Bank Corporation) and the Comptroller of the Currency (the regulator of the national bank) were supportive. Rather than being forced to sign a restrictive supervisory agreement with the agencies, the executives instead sold them on their developing strategy and business plan to transform the bank, which they reviewed with the agencies on a periodic basis.

As a consequence, no formal regulatory plan was required, which ultimately saved both parties a tremendous amount of time and energy.

Nevertheless, the years 1987 and 1988 marked the low point in Mellon's history, with embedded losses of $844 million and $65 million respectively. Profitability of $181 million would not return until 1989, and even then Mellon faced a larger than normal fourth-quarter provision for continuing credit losses.

Refocusing the bank for the future

In his role as CEO, Cahouet knew that Mellon had been following a failed strategy in its pursuit of becoming a money-center bank. Almost every new lending area that the bank had entered – commercial real estate, mortgage banking, energy, and LDC loans – was a source of the bank's credit problems. As soon as the immediate cost savings tactics were set in motion, he turned to resetting the bank's vision and strategy.

"In every bank turnaround situation, the CEO needs a strategic plan and a good story to tell right out of the starting gate," advises Cahouet. Knowing that the analysts and the press would be all over them soon, within 45 days the new team began publicly describing its new strategic direction.

Instead of staying the course as a money-center bank, Mellon would downsize first and then redefine itself as a super-regional bank following a balanced strategy, focusing on wholesale, middle-market, and retail banking as well as fee service businesses where they had competitive strength. Mellon had a significant advantage over most other commercial banks at the time with its higher level of fee income, which rose to 50 percent of total income by 1992. It was this focus on fee income, especially in Mellon's sizeable trust operations and other service lines, which would play a key role in its future strategic shift.

By the end of 1990, Mellon had progressed sufficiently to begin to engineer another defining strategic moment: the back-to-back acquisitions of The Boston Company and the Dreyfus mutual fund group between 1992 and 1994. Both of these companies played to Mellon's historical but underdeveloped strength as a trust and asset management company, and helped to leverage Mellon's considerable but largely untapped brand strength. "These acquisitions unlocked

Mellon's mentality to enable us to do new things and think outside the box," says Cahouet. "From that point forward, we were no longer just another super-regional bank, but we had entered the national scene on our terms in our own way." These moves would pave the way for more M&A and business development, a deeper appreciation by Wall Street for where the new Mellon Bank team was heading, and even more degrees of freedom for significant strategic shifts in the years ahead.

Recapitalizing the good bank by creating a bad bank

It was not enough to start the cost savings and reset Mellon's strategy; they also had to find a way to recapitalize the bank before it was too late. Cahouet and Smith had to devise an asset disposition and recapitalization plan that would convince the markets of their long-term viability and save them from potential regulatory intervention. They didn't have much time, and they needed $500 million in fresh equity capital – fast.

While at Crocker, they used a plan where their foreign parent provided capital to transfer nonperforming loans to a workout company. Mellon didn't have a foreign parent, and short of selling the bank, they had to come up with an alternative solution – and soon. Working with E.M. Warburg Pincus & Co., a New York venture capital group, they crafted a unique plan to tap into the junk bond market to finance the creation of a bad bank, known as Grant Street National Bank (GSNB), which was not a normal deposit-gathering bank. The plan was to transfer roughly $1 billion (book value) of Mellon's nonperforming assets to this new specialized bank subsidiary of the parent holding company, using the proceeds of two types of common stock offerings totaling $525 million to offset the loss in the transfer of the loans and the other bad assets at market value and to inject some much needed new capital into Mellon Bank.

As part of the transaction, they were able to spin off GSNB to Mellon's existing shareholders, and provide a class of stock for GSNB directors as incentive compensation. Grant Street had also entered into a management contract with another Mellon Bank subsidiary, Collection Services Corporation, to collect the bad loans on a "cost plus 3 percent of collections" basis working under the direction of the GSNB directors and management. This unit had a staff of more than 50 people with strong workout skills.

While a bit complicated financially, GSNB was a straightforward and relatively simple means of selling the bad loans quickly on a non-recourse basis in one lump sum, and simultaneously bringing fresh capital into Mellon Bank, thus allowing management in the good bank to focus on its strategy, core businesses, and return to profitability. A positive first sign was the fact that Mellon Bank did as much new business in the fourth quarter of 1988 – its first real operating quarter after the bad bank restructuring – as it had in the previous three quarters of 1988. The creation of GSNB also gave Mellon employees a psychological lift: with the bulk of the bad assets now separated from the good bank, employees clearly could see the light at the end of the tunnel and reflect that optimism to Mellon's customers.

Hard work on the part of investment bankers, lawyers, and accountants was required to make this novel plan a reality. By all accounts, GSNB was a complete success: it was structured well at the outset and had the right incentives in place, with a strong workout team who would return to Mellon Bank once their job was done. It completed its mission and returned its then unique bank charter to the banking authorities ahead of time. Mellon paid off its debt early, repaying the preferred stock held by Mellon and returning essentially all of the common equity invested in GSNB to its shareholders. Mellon's own stock immediately went up once GSNB was unveiled and contributed significantly to the fact that from July 1987 to December 1998 Mellon's total return to shareholders compounded at an annual 21.3 percent rate.

Mellon's postscript on the future

From our perspective, the work of the Cahouet team not only saved Mellon Bank from potential failure but also will go down in financial history as one of the great turnaround success stories of all time – without direct government aid. After 5 years of hard work, the bank turnaround effort was mostly over, and the tested leadership team could focus exclusively on repositioning Mellon Bank for the future by finding new ways to generate fee income and increase shareholder value. When Cahouet and Smith retired in December 1998, the market capitalization had risen to almost $18 billion.

* * *

Turnaround attempts fail more often than they succeed, no matter what the industry. Certainly in bank turnarounds failures have outnumbered successes. Yet even among successful bank turnarounds, Mellon Bank stands out. There was no magic involved, but there is a common set of actions, a need for hard work, and persistence to go the distance of a period of years not just months. Bank turnarounds can produce abundant rewards that await those investors and managers who move rapidly, comprehensively, and aggressively. Whatever the country or the particular bank situation – privately held, family-owned, or state-owned – there are real incentives for all stakeholders, especially customers, investors, and the economy, to get on with the business of bank restructuring.

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An Interview with Frank V. Cahouet – In His Own Words

Frank Cahouet is Chairman Emeritus of Mellon Financial Corporation, where he successfully restructured the company to position it for superior growth through a series of innovative moves, such as the creation of a bad bank to manage non-performing assets and the move into significant fee income through the acquisitions of The Boston Company in 1993 and the Dreyfus Corporation in 1994. Starting with Security Pacific Bank in 1960, he rose quickly through the ranks of a series of financial institutions, becoming Chairman, President, and CEO of Crocker National Bank (1984-86) and President and Chief Operating Officer of the Federal National Mortgage Association (Fannie Mae, 1986-87), before moving to save Mellon. He also has served as a coach and adviser to one of the largest Korean bank turnarounds in history. A native of Boston, Massachusetts, and a graduate of Harvard University and the Wharton School of Finance, he serves on a number of for-profit and nonprofit boards of directors.

In his own words, Mr. Cahouet shares his experience and advice with CEOs and senior management teams about the imperative of bank restructuring.

Getting started. *You managed some of the most successful bank turnarounds in U.S. banking history at Mellon Bank and before that at Crocker National Bank. How did you get started?*

I started my California banking career at Security Pacific National Bank as a loan officer, lending to fast-growing, but under-capitalized companies in Southern California. From this experience I learned a lot about what makes a company successful and also why some companies fail.

Over time, my responsibilities grew and a number of our small banking related subsidiaries were assigned to me to supervise and develop. We were quite successful, and we contributed an important part of our consolidated earnings. One assignment led to another, and eventually I was appointed chief financial officer. By then my experience in lending, portfolio controls, managing businesses, and operating as a chief financial officer made me a logical candidate to lead a major bank turnaround.

Setting the vision and strategy. *How did you reset the bank's vision and strategy in the early days when you were facing a crisis of confidence? Do you think it is different if a CEO is in the middle of a systematic financial crisis?*

In any turnaround situation, it is extremely important to articulate a strategy for your company that is creditable to all parties concerned: your employees, your customers, the community, and the financial markets. In situations where I have been involved, we have had to assess our strengths and weaknesses quickly, asking questions such as: were we serving the correct markets with the correct products; could we in the short term generate profits in these markets? If the answers were no, then we needed to withdraw from these markets in a constructive manner minimizing our exit costs. Our people had to understand the simple math of the business and be able to assess whether we were making money and covering our direct, indirect, and overhead costs as well as being paid appropriately for the risks being incurred.

As we rolled out our strategy, we frequently ran into some resistance. At the end of the day, our people had to accept the modified strategy or leave. If there is a systemic problem such as LDC or real estate portfolio issues, then it might make it harder to shift the strategy, but it still has to be initiated and then managed vigorously.

Leading the charge. *What specific actions did you take in the early days to set a strong leadership example?*

There is no question that a leader in a turnaround situation has to set a strong example. Some steps are quite simple: getting to work early; conducting well organized meetings that do not last too long; making decisions quickly and being able to adjust the decision later if you discover later that you have made a mistake. The company and all its audiences are constantly judging you. It is necessary to be viewed as being fair and willing to listen. You should constantly communicate with the staff in person, in print, or by video. Line managers should reinforce your message. The CEO must get around the bank and have many face-to-face discussions with all audiences. Sometimes when issues are particularly important and when it is useful for spouses of employees to understand decisions, we would send material to the homes. This was quite effective.

Building teamwork. *How do you assemble the right team from the start and find the right top management leaders to conduct a multi-year turnaround?*

Assembling the right team is a key success factor. One has to quickly assess the talent in the company. I have used all sorts of approaches including hiring one of the major search firms to assess our people. You have to make people decisions quickly. If you can, you may want to attract people you have known from other environments. This can be powerful, because as you bring talented managers on board who know you well it steps up the change process. You do not want to make wholesale personnel moves that aren’t necessary. You will never build loyalty to you and the company if you do.

Setting priorities. *What are the top three to four actions that you have to get right in the first 100 days to establish your control and credibility?*

In the first 100 days you had better figure out where the company is making money and where it is losing money. If you are faced with

major write-downs, you should not put off these hard decisions. Usually in turnaround situations, the previous management has been fairly aggressive in income recognition and expense deferral. A number two priority is evaluating your leadership team and making changes as necessary. In my view, the third most important step is articulating a plausible strategy to all of your audiences.

Managing stakeholders. *How do you manage all the various stakeholder expectations – customers, employees, investors, and regulators?*

To begin with, the best that you can. It is not easy, and you will not be totally successful. I have found that it is important to articulate your strategy, prioritizing the issues and, when you cannot satisfy a stakeholder on some issue, telling them you will not be able to meet their expectations. Most groups will accept the realities of the situation. In instances where they won't, I do not think you can let it bother you too much.

Ensuring a good customer experience. *How do you ensure a positive, service-oriented, trust-based "customer experience" in the midst of a total bank restructuring exercise?*

The first place is with your own people. They have to understand the importance of the customer and the need to meet customer expectations. Once your own people buy into the program, then the customer will tend to go along and try to make the organization successful. By and large, your customers are on your side; they want to help where they can. In many cases, they have had a long relationship with the organization and do not want to take their business to another bank.

Managing risks. *How do you reset and enhance risk management for the future, when often banks are left with a legacy portfolio of bad loans that result from poor credit practices and processes in the past?*

Getting risk management right is central to your success in turning a bank around. You must have very well-qualified risk management

leadership. They have to set out a specific program to include assessing the effectiveness of the risk management programs and then, where deficient, take all the necessary steps to correct the shortcomings. Frequently, when banks get into trouble there is a breakdown in the risk management process. This is often an indication that you must make changes in key personnel.

Building bad banks. *You managed one of the first and most successful bad banks ever. How did you do it, and is a bad bank approach easily replicated in other countries? What are the preconditions for success?*

How did we set up a bad bank, and can it be replicated in other countries? Absolutely. I think it has many applications in almost any industry and especially in the banking business.

We set one up because it was an obvious strategy. If we wanted to be successful, then we needed a major infusion of capital. The difficult part in setting up the good bank/bad bank strategy was to articulate a strategy that was understandable and attractive to all the stakeholders including the new money to be invested into Mellon Bank, the continuing good bank. Once we had accomplished this requirement, then it was just a matter of separating the bad assets from the good assets. We created a dedicated team to manage the bad assets, where they would be spending 100 percent of their time in liquidating the loan portfolio. Our creation of the bad bank – Grant Street National Bank, which had a national banking license, but did not accept deposits or make new loans – provided the Mellon Bank personnel with the time to focus on the good customers. Our experience with the customers, the employees, and the investors was very positive. I think this strategy has been replicated in other countries.

Cutting costs. *How do you make the tough decisions about the reduction of operating expenses – rationalizing branches, cutting overhead,*

and downsizing the employee base – that typically is a precondition for success?

For the most part, I think you should do it in waves by gathering the best information possible and setting targets somewhat arbitrarily. I believe it is important to do this quickly. I would rather set targets for my managers and then make sure that the costs come out against a target date. You must track how much progress you are making, and I believe it makes good sense to bring in outside help. I would be reluctant, however, to base any consulting compensation on a percentage of the costs taken out, because I think it raises a conflict of interest between the two parties.

Achieving performance. *How do you think about setting performance targets and then measuring and managing those targets during the restructuring?*

I am all for setting performance targets. Your managers and employees want to know what is expected of them and how they are being measured. I also believe you have the right to adjust these targets from time to time. As I said earlier, costs should come out in waves – do not try to do everything at once, because you can destabilize the company.

Creating good governance. *How important is good corporate governance in a turnaround, and should it start at the beginning of a restructuring or can it wait until the initial rounds are over?*

Good governance is important at all times, but especially during a restructuring. The board must be kept informed and agree directionally where the company is going. I do not believe that the board should attempt to manage the process. In fact, if it does, then I think it will cause damage. The board will have to give management room to operate, but it should be kept informed with board meetings every 2 months for example.

Restructuring state-owned banks. *Are the lessons you learned from Mellon Bank's successful turnaround applicable at other banks in other countries, including state banks where many problems exist today in countries as diverse as China, Indonesia, Russia, Turkey, and Argentina? What adjustments, if any, would you have to make for a state-owed bank?*

I think that the lessons we learned at Mellon will certainly be applicable in other countries. One must recognize that in many government-controlled banks they have a responsibility to support certain state-sponsored projects and programs, and understandably they do not always apply as strict credit criteria in extending credit as they would in a purely commercial environment. Nevertheless, they should be realistic about how they conduct their own business and properly evaluate the quality of their loan portfolio.

I would suggest that they split the portfolio into two segments. One segment would meet all of the credit standards of private sector banks, and the other portfolio would recognize the social considerations that were undertaken at the time the loans were made. The problem of commingling the portfolios is that you tend to contaminate the "good portfolio" with unprofitable lending which leads to bad loans, and then the lending officers become quite confused as to how to conduct themselves and manage different types of lending.

The examination process is critical. The central bank or the regulatory agency, which has the responsibility to evaluate loan portfolios, should use best auditing practices and not compromise their findings. In turn, this step will reduce the number of bad news surprises, which frequently result not only in shocks to the financial markets but also radical changes in senior management.

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