

Middle Market Under Attack?

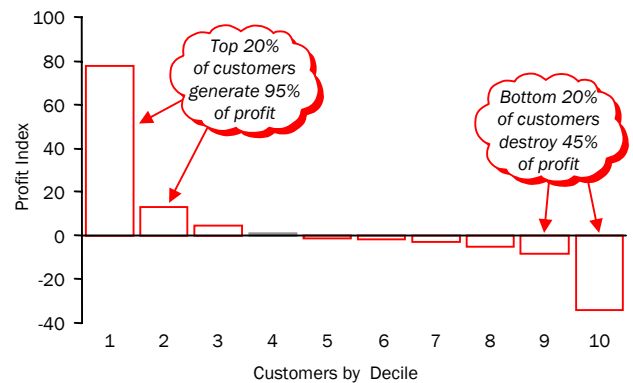
Strategies for Profit Acceleration

Commercial Banking (including small business and middle market) has long been an engine of solid growth through boom and bust cycles for retail banks. However, competition is becoming much more aggressive. Citi has recently acquired EAB, Wells Fargo is expanding in the midwest, and Bank One and FleetBoston are both placing increased focus on their middle market businesses. Non-traditional players like Merrill Lynch and American Express are also moving in with low cost plays that focus on alternate delivery channels and innovative product offerings.

The question for incumbents: Is this a threat that will expose some of the inefficiencies of your current business models and significantly erode profitability?

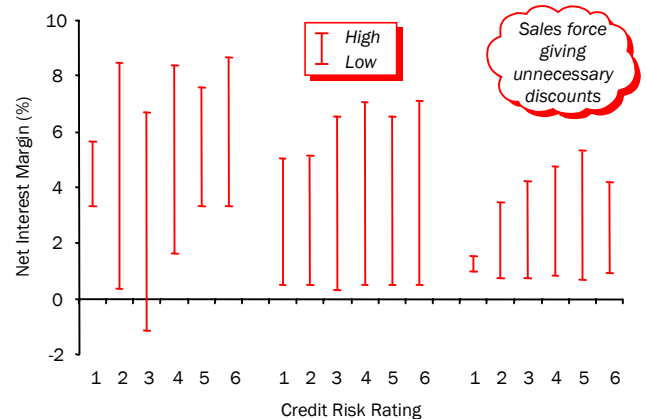
We at Booz Allen Hamilton believe that the current environment presents both opportunities and threats to banks. Today, over 50% of commercial banking customers are unprofitable in the United States (Exhibit 1). New entrants and aggressive incumbents have identified this chronic cross subsidization and are developing strategies to cherry pick the most profitable customers away from competitors. If they are successful, even with only a small proportion of companies, the implications for the overall profitability of some commercial banks could be catastrophic. Conservatively, a loss of 1% of your top customers could result in as much as a 25% reduction in total profit.

Exhibit 1
Commercial Customers Ranked by Profitability



Source: Booz Allen Hamilton analysis

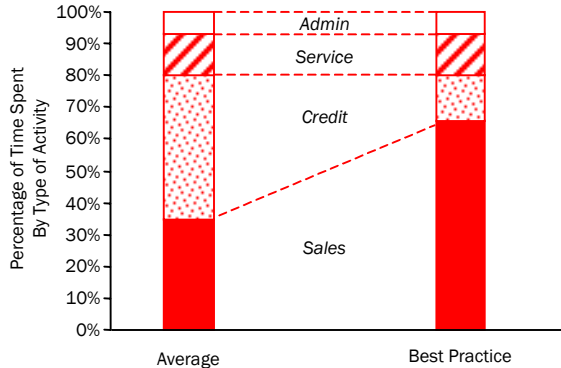
Exhibit 2
Variation in Price Versus Risk



Source: Booz Allen Hamilton analysis

Exhibit 3

Distribution of Relationship Manager Time



Source: Booz Allen Hamilton analysis

To counter this threat, banks must stop the cross subsidization and profit leakage. In our experience, three factors drive the bulk of the shareholder value destruction in commercial banking:

Factor 1: Inconsistent Customer Management Processes

The single biggest driver of value destruction is inappropriate pricing and fee waivers (Exhibit 2). Without the necessary decision support tools, such as customer profitability and wallet share analysis, relationship managers are using company revenues as a proxy for "value to the bank" and discount heavily to retain big name customers. These customers typically make up the most unprofitable 10% in the portfolio (Exhibit 1, Decile 10, on Page 1).

Factor 2: Uneconomic Sales and Service Models

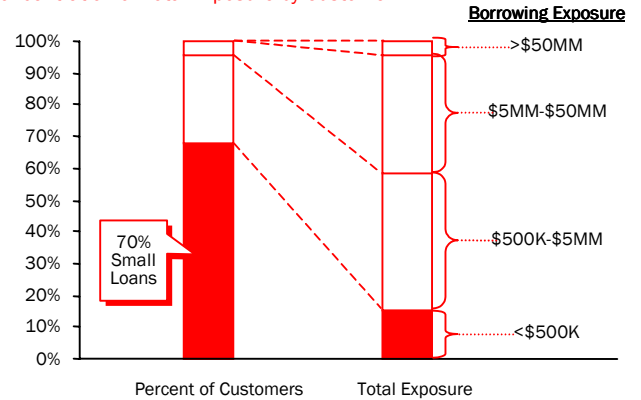
Local sales and service delivery historically has been considered the key to success for many banks. However, most small customers usually cannot generate enough revenue to afford the traditional high touch relationship management model. Deciles 6, 7, and 8 in Exhibit 1 are typically small customers that are unprofitable because they are being served largely through relationship managers on the ground. Changing to a mix of local and lower cost remote service delivery can provide good service at a cost that makes these customers profitable.

In addition, many commercial banks have relied too heavily on maintaining a local presence at the expense of developing deep sales force effectiveness skills.

As a result, most middle market relationship managers lag sales force best practices. Often many spend as little as 35% of their time on actual sales (Exhibit 3).

Exhibit 4

Concentration of Total Exposure by Customer



Source: Booz Allen Hamilton analysis

Factor 3: Credit Processes Not Aligned to Risk

Over 70% of commercial banking credit events are either small loans or small extensions to existing facilities (Exhibit 4). However, banks often treat small extensions with the same level of credit analysis as a large loan for a new customer. Lengthy write-ups for relatively minor extensions are not uncommon. This has two implications: First, the cost of credit, particularly for smaller customers, is far too high and second, the approval lead times are excessively long.

Streamlining processes to closely align credit effort with the risk of the specific credit event delivers significant reduction in cost to smaller customers while increasing overall service. For example, low risk events such as small extensions can be fast tracked through the process with minimal analysis (Exhibit 5).

By addressing the leakage factors outlined above, banks can both beat the new competitors and significantly improve their performance in commercial. However, it requires a major change from the one-size-fits-all business models that are common today. Superior performance requires adoption of a segment-aligned operating model that closely aligns delivery economics with customer value (Exhibit 6). Successful implementation can yield major bottom-line benefits. One of our clients achieved a market share increase from 15% to 21% and a cost/income ratio of 32% in less than 2 years.

While aspects of the design differ depending on market conditions, in our experience, the most successful commercial banking models display the following characteristics:

- **Customers segmented by value not size:** The common approach of segmenting customers by company revenue

Exhibit 5
Aligning Credit Effort With Risk

Fast Track	<ul style="list-style-type: none"> Small increases in the course of business for existing borrowers in good standing No "refresh" of financials Comments limited to validating good standing and appropriateness of purpose Reliance is primarily on customer being in good standing
Short Form	<ul style="list-style-type: none"> Small secured new borrowers and larger increases in the course of business for small borrowers in good standing "Refresh" of financials is required Comments limited to confirming "good financial health" Limited write-up and analysis unless trends are downward
Full Analysis	<ul style="list-style-type: none"> Applies to all new unsecured borrowers, all new large borrowers and larger increases of large borrowers due to a structural change in their business Full financial analysis and due diligence required Comments concise and structured along codified parameters Write-up, streamlined by use of codified and structured comments Full Credit Package

Source: Booz Allen Hamilton analysis

often results in inappropriate allocation of resources as size has no relationship with customer value to the bank. Segmenting by value enables a much closer alignment between customer profitability and cost to serve.

- Activities core to the customer relationship remain local:** For many banks, local presence has been the cornerstone of their success, particularly at the high end. Don't fall into the trap of pursuing scale at all costs. More than a few banks have seen large-scale customer attrition because they relied too heavily on 1-800 numbers.
- Levels of service differentiated by value:** Today there is often no tight link between level of service provided and the value of the customer. Operating models must be developed through an explicit understanding of both customer needs (what they want) and customer value (what the bank can afford).

- Non-customer specific activities consolidated to capture scale and reduce costs:** Almost all customers are indifferent to the location of low value servicing and credit activities. Don't leave them in the business centers in order to maintain customer service. Usually consolidating these functions in centers of excellence provides higher quality service at lower cost.
- Extensive use of decision support tools for the sales force:** Local knowledge and basic relationship management tools are no longer sufficient to maximize customer value. Sophisticated decision support tools, such as customer and product profitability, and wallet sizing are all integral to maximizing relationship manager productivity and individual customer value.

Exhibit 6
Example Segment Aligned Operating Model

Market Segment		Middle Market		Small Business		Micro Business
Channel		Relationship Banking	Priority Banking	Tier 1	Tier 2	Tier 3
Segment Proxies	Asset Exposure	> \$1.5M	\$250-\$1.5M	\$150K-\$250K	\$50K-\$150K	< \$50K
	Deposits	> \$5M	\$1M-\$5M	\$500K-\$1M	\$100K-\$500K	< \$100K
Connections/RM		45	100	400	1,000	10,000
Sales / Delivery Model	Relationship Management	Proactive			Reactive	
	Delivery	Distributed Delivery in Dedicated Centers	Distributed in Branch Hotdesks	Centralized Telephony Based		Dedicated Team
Service Model	Service Management	Named Service Support		Pooled Service for Segment		
	Delivery	Decentralized Business Center	Centralized in Service Center			
Credit Loan Model	Approval	Decentralized		Centralized		
	Underwriting Model	Team Consultation		Direct		
	Use of Full Analysis	Target < 20%	Minimal	None		

Source: Booz Allen Hamilton analysis

What Booz Allen Hamilton Brings

Booz Allen's financial services practice specializes in all aspects of commercial banking consulting. We have helped numerous clients throughout the world to significantly improve their profitability by implementing high performance operating models.

As a firm, we have been at the forefront of management consulting for businesses and governments for more than 80 years. Booz Allen combines strategy with technology, and insight with action, working with clients to deliver results today that endure tomorrow.

With 11,000 employees on six continents, the firm generates annual sales of \$2 billion. Booz Allen provides services in strategy, organization, operations, systems, and technology to the world's leading corporations, governments and other public agencies, emerging growth companies, and institutions.

To learn more about the firm, visit the Booz Allen website at www.bah.com. To learn more about the topics of greatest interest to the business community today, visit www.strategy-business.com, the web site for strategy+business, a quarterly journal sponsored by Booz Allen.

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