



frontiers in finance supplements

Consolidation and divestment in financial services

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FINANCIAL SERVICES

There is a range of forces currently driving consolidation, divestment and corporate reconfiguration in the financial services sector. Many aspects of the financial crisis and its aftermath are helping to accelerate these processes. However, many of the critical strategic decisions necessary are neither simple in principle, nor easy to implement in practice.



Several forces are encouraging divestment, consolidation and reconfiguration in financial services: renewed focus on core business, retreat from complexity, new business models, scarcity of funding and a move to better quality products.

External pressures are also increasingly powerful. Regulators and politicians are struggling to formulate policy on whether institutions can be 'too big to fail', and if so whether they should be encouraged to split themselves up. Over-powerful financial institutions can also give rise to concerns about anti-competitiveness. For example, recent consolidation of banking in the UK has caused concern in the EU, which could lead to directives for divestment.

Public policy

However, intervention by the authorities is not a straightforward process. For every divestment, there has to be a purchaser. Public policy objectives may not be met by a sale of part of a business to another equally large and/or competitively dominant player. Many institutions are now contracting back to their home locations. Banking and insurance are becoming less globalized. The players most likely to be in the market to acquire pieces under disposal will be other domestic players of comparable size. Simply moving the deckchairs around is unlikely to increase systemic robustness or competition within the sector.

There are some large alternative pools of capital, for example in the Middle East¹ and China. In principle these could be available as

newcomers to buy up divested assets. But some early investments in distressed sales have resulted in book losses. Do such investors want to make further inroads into the market? And what are the policy and political implications for some European and US institutions of having substantial Middle Eastern or Asian shareholdings in key financial institutions?

Strategy and target operating models

From broad vision to implementable strategy is a big step. A divestment decision should be taken on the basis of a detailed understanding of the current business, accurate segmentation and fine-grained attribution of revenue, costs and profits. Defining an achievable target operating model depends on it. While this may seem obvious, the fact is that many financial institutions lack

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the basic data and the management information systems necessary to undertake such analyses with confidence. Insurance companies, in particular, appear to be behind the game in many of these areas. While significant investment has been reported as being made in information systems, this can actually make divestment decisions more complex at present. And a number of recent trends have helped to complicate the separation process further.

Many banks, for example, now contain non-banking operations such as insurance. So what might be sold, could be a complex mix of businesses which the purchaser may want to rationalize further. Some banks looking to acquire a banking operation may have to take an insurance operation too, and then sell it on. The final resting place of a divested operation might be in a third party.

Some of the key risks and challenges

A key principle to consider here is that the greater the extent to which a transaction can be de-risked by initial design, the greater the potential value and the higher the possible price. A deal done under pressure, with a less-than-willing buyer and/or seller is likely to have lower value. However, reducing transaction risk is a major challenge.

For example, over recent times, institutions have streamlined costs, simplified and centralized operations in the interests of efficiency and savings. This can make it all the more difficult to achieve separation of individual operating centers in

practice. In particular, systems issues are likely to be among the most challenging. Disentangling common centralized platforms can be very time-consuming and costly. It may be necessary, for a transitional period, for the seller to continue to offer backroom services to the buyer under a transaction services agreement. But this can bring its own challenges: operating such a service on an arms-length contractual basis is not core business for the seller. Issues of compliance, service levels, confidentiality and competitiveness are almost sure to arise and need careful and active management.

There are likely to be significant people issues also. New contracts, terms and conditions will be needed. Many companies have group shared services centers. Once again the challenges of separation, determining who goes and who stays should not be underestimated. In our firms' experience, CEOs and CFOs should consider carefully three critical issues:

- does the company have the management and leadership in place to survive the divestment journey?
- does it possess the 'craft skills' necessary to manage the process of change – project management, technology, systems, book closures, run-offs – and how will it cope with those skills becoming redundant at the end of a separation project?
- does senior management have the depth of industry expertise to get the right answer and make sure it happens? In many large multinational banks, this may well be so, but in the insurance sector, expertise can often be more shallow.

Regulation and impact

Many regulators in both banking and insurance are likely to be taking a close interest in the impact of proposed separation and divestment. While not as pronounced, regulatory pressures on fund managers are also expected with regulators drafting new rules, most notably these target alternative investment managers.

Also, the fact that real estate and infrastructure funds, for example, are exposed to the banking sector could lead to heightened regulatory scrutiny in the future.

Although pressure from regulators may be a driving factor in encouraging divestment, often overlooked are its potential effects on the regulatory capital requirements of the newly configured seller and buyer alike. Divestment of a specific operation may rob the remaining business of regulatory capital benefits previously enjoyed by the group as a whole. The capital adequacy position should also be well-understood, well in advance, and the consideration for a deal struck on the basis of an accurate understanding of its overall economic value.

Brand and reputation

Finally, there are brand issues to consider. Few complex financial institutions outside pure holding companies maintain a multi-brand strategy. It is expensive, and unless different brand offerings are aimed at distinct market sectors, brand synergies cannot be maximized. But where an institution decides to divest part of its operations, there can be significant challenges in brand separation. And if the purchasing entity decides to re-brand some or all of the acquired offerings, then there may be considerable brand and goodwill impairment to be factored into the deal².

Major change, major challenge

For very many reasons, divestment and separation are going to be high on many institutions' agendas in the next couple of years. But the scale and complexity of the task should not be under-estimated. Divestment may be a strategic imperative. But that seems to make the challenges of getting it right more difficult, not less.

1. 'Spreading its wings: Private equity in Israel – growing internationally', *Returning to level flight: A new path for financial services*, frontiers in finance, KPMG International, September 2009.
2. 'How do you want to be seen?', *Returning to level flight: A new path for financial services*, frontiers in finance, KPMG International, September 2009.

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