Chapter1

Introduction

The financial crisis that started in 2007 and then reached the climax in the last months of 2008 and the beginning of 2009, after the collapse of the Lehman Brothers investment bank, has led to the most dramatic fall of the economic activity during the post-war era. The global banking system was almost paralyzed, capital markets collapsed, numerous countries and companies found themselves close to bankruptcy. As a consequence, the world economy experienced, for a first time since the 1930's, a full-scale global recession.

As a result, the global financial system was destabilized due to high interdependences of the markets worldwide. This led to high losses of the banking sector which reached trillions of dollars (International Monetary Fund 2008). In their fight against the crisis, governments and central banks are ready to use unprecedented methods, including massive quantitative easing of the money supply on the one hand, and giant stimulation packages, rescue operations for banks, and even temporary nationalization of financial institutions on the other.

To find out what the main consequences are and what has to change, it is necessary to figure out about the roots of the crisis. These will lead to mistakes being made by banks and point out the areas of mismanagement. At the end this should lead to main recommendations about the future behavior of the banking sector such as the consideration of aspects that are relevant to the creation of a proper business model that successfully meets the challenges of the changed global financial market.

1.1 Background to the research

It is not only the crisis that leads to the necessary changes in the banking sector. New technologies and changed customer needs and behavior, deregulation and internationalization of markets such as collapsing banks and even countries are affecting the business models of financial service companies sustainably: This research is based on the assumption that existing business models are obsolete and partly no longer meet the requirements of the market.

Existing business models of companies should be critically examined. New and innovative business models must be developed, in order to compete successfully in the market of the future. There is no consensus about what exactly a business model is, i.e. in which dimensions this can be described and what the relationship with other strategic outcomes is. In addition, no holistic representation of a method is known which describes how companies can derive useful business models.

The purpose of this study is to add to the existing current knowledge, the changing factors to the strategies of financial businesses, especially for banks. It was shown that the way of making business in the past was not sustainably successful while the economy had to deal with a financial crisis being released by the financial market. That’s why one of the goals of this study is to identify main success factors for bank business strategies.

This work is performed to contribute to the definition and determination of business models for financial institutions. A proposal for a business model that can succeed inthe present day requirements to stand on the financial market shall be described from the findings.

The intention of this study is to meet the need of the banking business to adapt to the new challenges in the financial market. That means banks have to rethink their way of doing business. Different reasons lead to this change, for example BASEL III, partly collectivization of banks, thus loose of independency.

In the introduction, an overview of the challenges for financial services (banks) will be given first. In the next chapters, the problem is substantiated; the objectives of the work and the research methodology will be described and pointed out. The description of the structure of the work completes the chapter.

1.2 Purpose of the research

This work deals with the role of banks in the context of the Subprime crisis. Many banks suffered from high deductions due to the crisis because of a lack of equity capital. This weakened many banks and that's why it is time to rethink their business model of "maximum profit by high risk". Banks which focused on commercial banking and concentrated on regional markets had fewer problems during the crisis. At the same time banks having a large investment banking field were more affected. The reason for that is that they have less risky businesses and grant more stability. Probably there has to be a trend to the more stable and less risky financial services.(Bloss et al. 2009, p. 109)

The study aims to give an overview of nowadays business models of banks. Therefore the analysis will take part at the strategic level of a bank and what mistakes were made on this level. The researcher intends to find out what strategy the banks follow and if it was successful or not during the financial crisis.

Having collected the main key factors within the strategies of the banks, the next step will be to present the main issues for new business models for banks to establish a strong position in a more regulated and competitive banking sector.

1.3 Challenges for financial services today

The financial markets are in an extremely dynamic change, which is due to many reasons which have to be identified. Especially since 2008(tagesschau.de 2008), when the financial crisis began after the US real estate market collapsed, the financial market faced many problems. Therefore, in the introduction, a brief overview of the essential elements which are responsible for the change is created. The presentation is based on the proposed ways of viewing the environmental conditions. The individual ***variables*** comprise the macro-economic, political-legal, technological, socio-cultural and ecological environment. The orientation on the environment sphere might guarantee sufficiently deep insight into the changes in the banking industry (see Chapter 2.1).

1.4 Researchproblem

Although in recent years a number of new or modified financial services were introduced in the market, partly with an impact on the value chain and market structure it is known only little about these services or products. Both, new inventions as well as for the further development of services -scheduled operations- take into account the design of cooperation and the change in the value chain. In contrast to the development of technical products the systematic development and improvement of services for a long time has been given no key role. In practice, there are gaps in knowledge about the use of systematic methods for service development, because there is no comparable industrial design teaching discipline for services. The situation in the development of service systems is quite similar to the situation of the industrialization methods research at the beginning of the 60s or software development late 70s.

It is also part of the development of new business models beside service innovations to critically analyze the value chain and to identify potential cooperation and the possibilities of new communication channels.

For a description of a business model including information regarding the services and products offered, the distribution of the necessary resources and information on the design of cooperation is important. Because of their flexibility, many well-known methods of strategic planning and innovation management can be used for financial services as well. The specifics of financial performance retaken into account, since they are not always comparable with other industry.

In summary, following areas of knowledge are relevant for the development of methods for the derivation of business models:

Strategic Planning

Service innovation and development

Cooperative development and design

Inclusion of knowledge about the digital economy

1.5 Objectives and scope

Objectives

1. Find out the reasons for the outbreak and examine what happened in consequence to the crisis and

2. Elaborate the legal changes due to the crisis and the basic changes for a bank business model

3. Derive and propose an ideal bank business model from the findings at the end of the thesis.

Scope

The study can be separated into three main parts:

1. Theory by literature review (strategy, business model and the crisis)

2. Legal, regulatory view on the problems

3. Internal view of a bank to the problem

1.6 Research question

Based on the current challenges which were formulated at the beginning of the work, the reader should be able to answer the following research questions at the end of the study:

> ***What are the external and internal changes in the banking sector due to the crisis?***
>
> ***What are the identified success factors to be implemented into an ideal sustainable international bank business model?***

1.7 Connectional framework

The purpose of the conceptual framework is to lift out and present the main things to be studied (Miles & Huberman 1994). The research questions concern how the banking sector changes and how banks have to adapt to the new environment.

Based on the findings from the literature that has been discussed above, the researcher needs to identify the data that must be collected in this research. It was shown from the discussion above that there are two main blocks to be investigated.

1. External block

2. Internal block

It came out that there were made crucial mistakes that led to the crisis. The scope of the research is to find out by interviews and case study what went wrong and what has to change in the financial sector and to extrapolate recommendations what actions have to be taken to avoid another crisis. The information the researcher wishes to get is how a bank has to change its business model and what has to change on the legal stage. The results shall support the findings from the literature about solutions to reorganize the financial sector. To describe what solutions were mentioned the keywords at the end of the last chapter will help.

The case study is supposed to identify the mistakes made and what the reasons of the certain bank were to get into such a trouble. The next step will be to carry out a survey which will support the identified factors and find out what ideas the interviewed persons have to avoid future crises. Fig. 2.14 shows the conceptional diagram of the research:

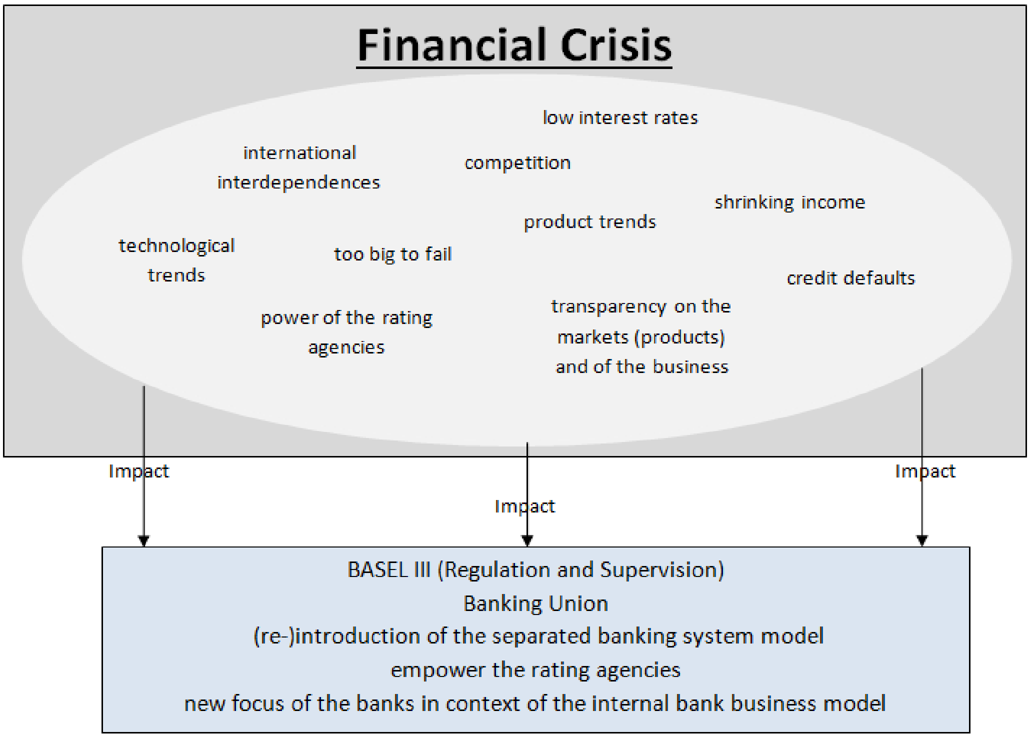

Figure 1-1 Conceptional diagram of the research

The background of the study is the financial crisis the banking sector faces since 2007. There were different factors that led to the worst crash since 1929. Hence, this crisis revealed the deficiencies first of the banking sector as a whole and of the particular financial institutions on the other hand. These facts had and still have consequences for the whole financial sector. The consequences have an impact on the legal and business policy level.

1.8 Structure of the thesis

Once in chapter 1background information have been given, the purpose and the research methodology, question, design, problem, the significance and target group is explained, in Chapter2, the theoretical foundations that are relevant for the derivation of a business model will be worked on. This includes the disambiguation of strategy and business model in the context of strategic business areas and business units. The specifics of financial services will be worked out. The methods will be described: successful and unsuccessful strategies of banks, reasons for collapsing bank strategies, methods of strategic planning. Existing concept shall be analyzed of their solidity.

In Chapter 3,the research concepts will be presented in detail - the selection of the case (Lehman Brothers) and the question such as the design and process of the analysis.

In Chapter 4 the practical part will start by doing the case analysis and the analysis of the questionnaire.

The next chapter is formulating a conclusion on the thesis. The summary of the results, their critical appraisal and the views include the work from Chapter 5.

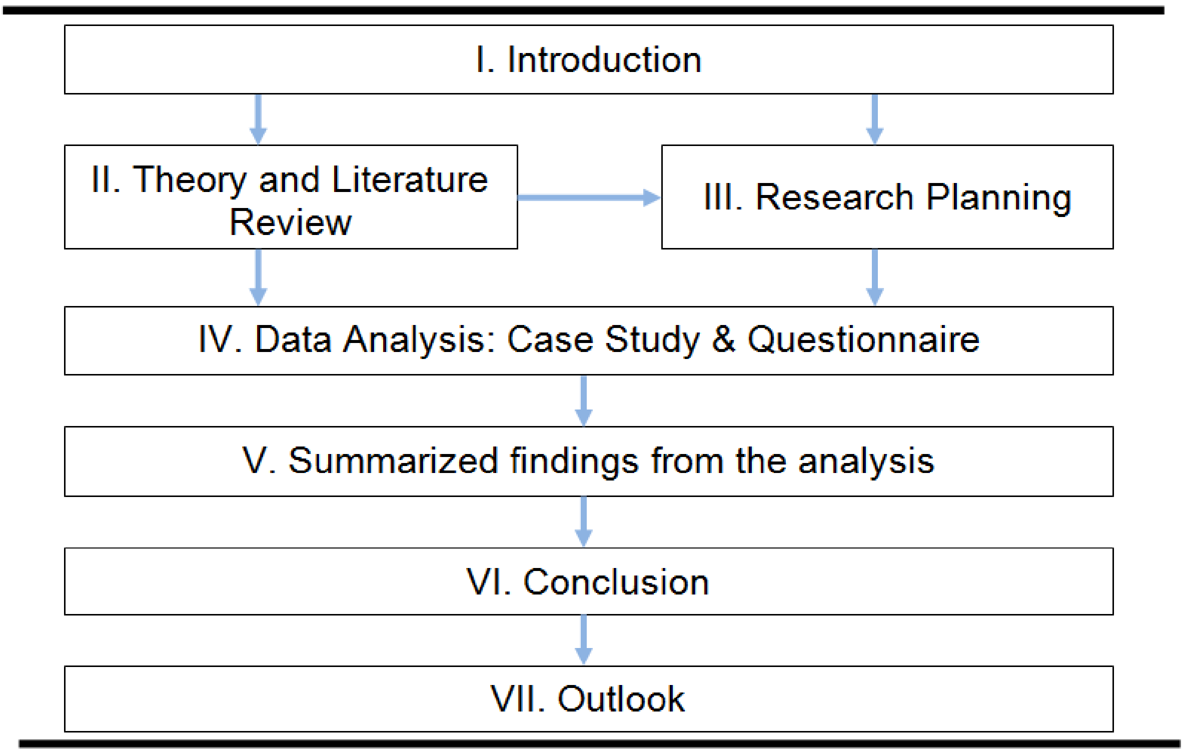

Figure1-2 Structure of the Thesis

1.9 Definition of the terms

Asset Backed Securities (ABS)

An Asset-backed security is a debt security, from which payment claims against a special purpose vehicle are arising. Wherein the SPV's liquidity is mostly used for the purchase of receivables usually from several creditors and collateralizes these into a security.

BASEL III

A comprehensive set of reform measures designed to improve the regulation, supervision and risk management within the banking sector. The Basel Committee on Banking Supervision published the first version of Basel III in late 2009, giving banks approximately three years to satisfy all requirements. Largely in response to the credit crisis, banks are required to maintain proper leverage ratios and meet certain capital requirements.

Business model

A business model describes the rationale of how an organization creates, delivers, and captures value (economic, social, cultural, or other forms of value). The process of business model construction is part of business strategy.

Business strategy

A business strategy typically is a document that clearly articulates the direction a business will pursue and the steps it will take to achieve its goals.

Capital stock

Capital stock represents the size of the equity position of a firm and can be found on the balance sheet of a typical financial statement.

Collateralized Debts Obligation (CDO)

CDO is an umbrella term for financial instruments that belong to the group of asset-backed securities and structured credit products. CDOs consist of a portfolio of fixed income securities.

Collateralized Debts Swaps (CDS)

A credit default swap is a credit derivative that allows to trade credit risks on loans, bonds or debtor name.

A CDS is a contract between two parties, which refers to a Reference Entity (as the base value). Reference Entities are typically large, publicly traded companies. One contracting party, the so-called secured party, pays an ongoing payable and additional one-time premium that has to be paid at the beginning. Therefore he receives from the other party, called the guarantor, a compensation payment if the referred debtor of the CDS contract defaults.

So the CDS is similar to credit insurance. However, the secured party receives compensation payment regardless whether to him any damage occurs by the failure the reference debtor.

Economies of scale

Economies of scale in production theory, in business management and in microeconomics, are defined as the dependence of the production volume from the production factors used.

Glass Steagall Act

Glass-Steagall Act is the name of two federal laws of the United States of America. The name to the American federal laws was given by Senator Carter Glass of Virginia and Congressman Henry B. Steagall, both from the Democratic Party.

The first law was passed on 27 February 1932 by President Herbert Hoover and served to curb deflation during the Great Depression.

The second, more important law, the Banking Act of 1933 was signed on 16 June 1933 by President Franklin D. Roosevelt. The Glass-Steagall Act, called Banking Act prescribed the introduction of a two-tier banking system, i.e. an institutional separation between the deposit and lending business and the securities business.

Special Purpose Vehicle (SPV)

SPV's are used mainly for structured finance. Thus, access of financing creditors to the assets of the investor shall be avoided -so-called on-or limit recourse financing-and the Funding should be protected against insolvency risks from the sphere of the investor (bankruptcy-remote). These companies are usually founded as capital companies to limit the liability.