Turning Around Investment Banks During the Financial Crisis: Surviving Apart from Government Bailouts

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ABSTRACT

The principal topic of this paper addresses optimal turnaround strategies that businesses employ to reengineer value during times of financial distress. The scope of the paper focuses on investment banks during the financial crisis, which, according to the National Bureau of Economic Research, began in December 2007 and ended in June 2009. During that time, the world’s financial system faltered and many banks and lending agencies across the globe faced turmoil. Governments were forced to step in to mitigate the disaster and to ensure that the largest businesses across industries did not cause a total collapse of the world economy. Amongst the largest investment banks some failed or were acquired and some survived the crisis. In this paper, we set out to answer the question: what turnaround strategies did investment banks employ to survive the financial crisis apart from taking government bailout money and restructuring legally?

To answer this question we performed three levels of analysis: 1) researched the most effective turnaround ‘levers’ found through empirical academic studies; 2) researched accepted best practices from turnaround management firms; 3) interviewed numerous investment bankers, academics, and other financial industry professionals about their experiences during the crisis.

Research and interviews revealed that one bank in particular, Goldman Sachs, took three steps that align with ‘levers’ found to be statistically significant in turning around financially distressed firms. It, 1) identified the root cause of the problem before taking a course of action; 2) took a growth oriented, strategic view and invested significant resources and time to ensure long term success; 3) communicated to clients and employees effectively and frequently about the short-term realities and its long-term commitments.

We conclude that, while there are effective steps any business manager can take to turnaround a firm from financial distress, there is no set formula. The levers themselves are conceptually simple but difficult to execute in stressful and uncertain circumstances. Successful turnarounds arise when organizations execute prudent plans efficiently. Execution is efficient when organizations are able to unveil a problem at its core, adapt with the right sustainable solution, and unify individuals within an organization over a short time frame.

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1 Introduction

Recovering from a crisis is an area in which specialists have devoted their life studying across many different fields whether it be medicine, business, or political theory. We have a particular interest in business crisis recovery because of our passion for management as Sloan students. Business history has seen periods of booms and busts, innovation and technological advancements, the evolution of new strategic frameworks, and shifts in labor market demographics. The pre-Socratic Greek philosopher, Heraclitus of Ephesus, wrote almost 2500 years ago that over time, “the only thing constant is change.”

As change continues to shape the world, we will inevitably encounter new periods of crisis as well as prosperity. The National Bureau of Economic Research (NBER) reports there have been 32 U.S. recessions since the mid-1850s. Understanding how business organizations are able to recover from periods of distress is the fundamental motivation of writing this thesis. Our paper sets out to discover the turnaround strategies, apart from government bailout funding, that enabled investment banks to emerge successfully from the 2008 financial crisis. Is there a unique algorithm that can be applied to reengineer corporate value? Is there a secret recipe to be discovered?

Our methodology for discovery is not analytically quantitative. Instead, the construct for our methodology involves, first, the analysis of existing academic research to establish material turnaround levers in a general setting, second the analysis of practical published processes that turnaround management experts currently use, and third the analysis of observations collected through interviews with financial service professionals. We conducted the majority of our interviews with investment bankers. After providing these three layers of analysis, we were able to identify patterns and consistencies that provided us with a deeper understanding of our research question. Before we
synthesize our first layer of analysis for the reader, allow us to provide a brief background of the 2008 financial crisis as context for this paper.

2 Context

To understand the effective turnaround strategies employed by financial service firms during the crisis, it is important to understand the cause of the crisis and its effect on these firms. The sheer breadth and scope of the institutions and geographies affected make the situation incredibly complex. We will provide a high level overview of the crisis to put our research in context. First, we include a qualitative description of a few influential drivers that shaped the consumption and investment behavior of the U.S. economy leading up to the crisis, and secondly includes the quantitative macroeconomic picture during the crisis.

2.1 Overview of Causes

Beginning in the early 1990s the U.S. government began promoting policies that influenced the consumption and investment behavior of the American economy. We will highlight three in particular that we believe had a significant impact on the outcome of this crisis.

The first allowed more Americans, regardless of income or credit score, access to housing. The theory behind this effort was that home ownership would ultimately lead to a more financially stable populace. Congress passed the Community Reinvestment Act and the affordable housing “mission” that mandated
all mortgage offering banks, Fannie Mae, and Freddie Mac to sign a percentage of the mortgages they
offered over to under qualified home buyers.¹

The second, the repeal of the Glass-Steagall act in 1998, allowed commercial banks and investment
banks to merge.² After the market crash of 1929, Congress mandated that the speculative behavior of
investors needed to be separated from commercial banking activities.³ The repeal meant that banks
who held main street dollars in deposits could also engage in the risky activity associated with
investment banks.⁴

The third, the SEC’s adjustment of capital requirements and leverage laws in 2004, allowed five banks on
Wall Street (Goldman Sachs, Morgan Stanley, Merrill Lynch, Lehman Brothers and Bear Stearns) to take
unlimited leverage.⁵ This replaced the 1977 net capitalization leverage limit of 12-1. Banks could lever as
high as 40-1.⁶

Banks and lending agencies responded to the affordable housing mandate by either keeping the risky
mortgages on their books or bundling them with safer mortgages and selling them as securitized assets
to investment banks and other speculative firms. These were known as mortgage backed securities

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Books, 2010), 34.
⁵ Ibid.
⁶ Ibid.
(MBS). Fueled by the booming housing industry and increase in mortgages, the market for MBS took off and investment banks from around the world entered the trade.\(^7\)

Additionally, as a result of the dot-com crash in 2000, the Federal Reserve’s lowered interest rates to 1% to stimulate an economic recovery.\(^8\) For asset managers seeking to find investment positions for their clients in a low interest rate environment, municipal bonds and treasuries were unattractive;\(^9\) rather investors were attracted to gaining exposure to the high-yield mortgage market. From 2000 to 2007, there was a rally in home prices that expanded the MBS trade.\(^10\) However, asset managers needed to mitigate the high-risk exposure of these investments and did so through credit default swaps (CDS).\(^11\)

CDS are a type of derivative that provides insurance against the credit default risk of another asset.\(^12\) For example, if a buyer holds an investment position in a tranche within a pool of subprime mortgages and is seeking to hedge the risk of that tranche (the reference entity in Figure 1 below), he or she can purchase an insurance-like contract on that asset, called a CDS.\(^13\) In the event that the tranche defaults, declares bankruptcy, is downgraded, or some other negative “credit event” occurs, the seller has to pay the buyer.\(^14\) The CDS effectively is an agreement that transfers the credit risk of the tranche from the buyer to the “protection” seller in exchange for a periodic fee.\(^15\) The upside for the seller is the stream of income paid by the buyer to the seller during the contractual life of the CDS while a negative event does

\(^9\) Ibid.
\(^10\) Ibid.
\(^11\) Ibid.
\(^12\) Stulz, René. “Credit Default Swaps and the Credit Crisis.” Journal of Economic Perspectives 24 (2010): 77.
\(^13\) Ibid.
\(^15\) Ibid.
not occur. The downside for the seller is when an adverse event occurs and he or she has to pay the buyer. Please see figure 1 below for an illustration.

Figure 1

Source: International Swaps and Derivatives Association

JP Morgan created the first CDS Contract in 1997. According to the Depository Trust and Clearing Corporation’s Trade Information Warehouse, "the gross notional amount of all CDS contracts outstanding was $25.9 trillion at year-end 2011 and the net notional amount as of that date was $2.7 trillion."  

By 2007, trillions of dollars in MBS and CDS remained on the balance sheets of banks and lending agencies around the world. The fast growth in the CDS market ultimately exposed domestic and global financial institutions to housing price declines and defaults. Lead investment banks, AIG, and other major organizations acted as the primary coordinators of these assets, exacerbating systemic risk. The top investment banks financed these trades with unprecedented levels of debt after the SEC adjusted leverage controls in 2004.

16 Ibid.
19 Ibid.
Moreover, credit rating agencies such as Moodys, S&P and Fitch assigned AAA ratings to many MBS, implying they were just as safe as U.S. Treasuries. This allowed asset managers to further justify their positions.\textsuperscript{20} When reexamined post-crisis, the rating agencies were believed to have exaggerated the safeness of these assets.

Many suggest the first signs of trouble occurred in late 2007 when housing prices in California started to fall. As the value of the mortgages diminished, so did the value of the MBS. In only a few months, these once highly sought after assets became worth much less. Banks and financial institutions that sold CDS had to pay the owners of the CDS policies, but did not have the cash on hand to do so or the ability to raise funds because of the decline in the value of their collateral (i.e. the MBS assets on their balance sheets). These events had a profound impact on the global economy.

2.2 Employment Picture

According to the National Bureau of Economic Research, the recession from the most recent financial crisis began in December of 2007 and ended in June 2009.\textsuperscript{21} It lasted 18 months, and marked the longest recession since World War II, which until that point was 16 months.\textsuperscript{22} The U.S. unemployment rate in December of 2007 was 5.0%.\textsuperscript{23} By the end of the recessions in June 2009, the rate jumped to 9.5%.\textsuperscript{24} The

\textsuperscript{20} Ibid.
\textsuperscript{24} Ibid.
unemployment rate peaked at 10% in October 2009. On a state level, Nevada, California, and Michigan suffered among the worst unemployment rates. On an international level, the U.S.' unemployment rate ranked one of the highest among industrialized countries. Employment in construction and manufacturing industries both suffered the largest percentage decline of 13.7% and 10.0%, respectively (from the beginning month to the last month of the recession). Please see figures 2-5 illustrating the severity the 2008 financial crisis had on unemployment rates.

Figure 2

Unemployment rate and long-term unemployment rate, January 1948–December 2011, seasonally adjusted

Source: U.S. Bureau of Labor Statistics

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25 Ibid.
26 Ibid.
27 Ibid.
28 Ibid.
2.3 Resolution

From the beginning of the crisis, it became apparent that government intervention was needed. The Troubled Asset Relief Program (TARP) was created on October 3, 2008 through the Emergency Economic Stabilization Act. The act authorized the Treasury to purchase $700 billion of illiquid mortgage-backed securities and additional assets from companies to inject liquidity into the markets. The Dodd-Frank Act and Consumer Protection Act reduced the final amount to $475 billion, which was injected into the

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banking system, the auto industry, mortgages for US citizens, and AIG. The Treasury Department allocated TARP funding in the following way.

- “Approximately $250 billion was committed in programs to stabilize banking institutions ($5 billion of which was ultimately cancelled).
- Approximately $27 billion was committed through programs to restart credit markets.
- Approximately $82 billion was committed to stabilize the U.S. auto industry ($2 billion of which was ultimately cancelled).
- Approximately $70 billion was committed to stabilize American International Group (AIG) ($2 billion of which was ultimately cancelled).
- Approximately $46 billion was committed for programs to help struggling families avoid foreclosure, with these expenditures being made over time.”

Additionally, the US government took over Fannie Mae and Freddie Mac for $187 billion, who, together, held approximately $5 trillion in mortgages on their books.

By 2010, the FDIC considered 14% of the financial institutions in the U.S. as either “problem institutions” or as “failed.” To survive, banks accepted TARP money and some restructured to bank holding companies. These are the most commonly covered outcomes in popular media from the crisis.

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31 Ibid.
32 Ibid.
33 Ibid.
Evaluating the actions financial institutions performed, besides accepting bailout money and restructuring, is the focus of our paper. Before we evaluate the turnaround actions of investment banks during the crisis, we will provide our first and second layer of analysis outlined in our introductory paragraph. As a reminder, our first layer analyzes existing academic research to establish general turnaround levers. Our second layer analyzes the practical published processes that turnaround management experts currently use. Examining academic studies and industry best practices will allow us to highlight the important steps investment banks took to survive the 2008 crisis.

3 Turnaround Strategies From Academic Research and Industry Professionals

According to Ian Mitroff, professor emeritus at USC Marshall School of Business, firms that handle disasters of any kind most successfully are prepared beforehand by empowering “crisis management teams.” These are multi-functional and multi-level teams with a pre-determined action plan to address the problem, isolate it, and communicate to key stakeholders. Nevertheless, most firms lack a disaster preparedness team or plan, and management often acts reactively.

There exist a range of prescriptions in strategy literature and financial research on corporate turnarounds and the various levers used to recover from periods of distress. To that end, we will provide a distillation of the most effective turnaround methods from academia and industry professionals.

3.1 Academic Studies

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36 Ian Mitroff, interview by David Hoyme and Joseph Farias-Eisner. Cambridge, MA Phone Interview, March 4, 2015.
37 Ibid.
The British Journal of Management's *Corporate Financial Distress and Turnaround Strategies: An Empirical Analysis* highlights the fundamental components of turnarounds as a tool to re-engineer corporate value. The authors, Sudarsanam and Lai, examined a sample of 166 potentially bankrupt UK firms during 1985 to 1993 and analyzed their turnaround strategies over the three years after distress.\(^{38}\) In addition to the data they collected from this sample, they also performed broader research across academic literature on turnaround strategies. From this broader research, they found that there are four main levers that companies use:

1. Operational restructuring
2. Financial restructuring
3. Asset restructuring
4. Managerial restructuring\(^{39}\)

The conclusion they construct based on their empirical analysis of the 166 potentially bankrupt UK firms shows that of both recovery firms and non-recovery firms: 1) both sets implement similar strategies pulling one of the four levers described above; 2) non-recovery firm managers restructure more intensively than recovery firms; 3) non-recovery firms are less effective at implementation than recovery firms; and 4) non-recovery firms are short-term focused, engaging in fire-fighting strategies, while recovery firms take a growth-oriented and external-market focused strategic position.\(^{40}\) Moreover, recovery firms choose investment and acquisition to rescue them in distress, acting more forward-


\(^{39}\) Ibid.

\(^{40}\) Ibid.
looking and expansionary, while non-recovery firms are more internally focused, adopting operational and financial restructuring strategies to rescue them in distress.\textsuperscript{41} We will look at each lever in turn.

1. Operational Restructuring

This lever aims to improve efficiency and margin by prioritizing the reduction of direct costs and overhead. Its primary aim is to generate short-term cash flow and profit improvement, acting as a firefighting technique and differing from the restructuring that assumes a longer-term competitive positioning and performance focus.\textsuperscript{42} Operational restructuring consists of cost reduction, revenue generation, and operating asset reduction strategies, and has been cited by C.W. Hofer in the Journal of Business Strategy to be the first turnaround strategy that distressed firms implement; Hofer notes other strategies are less important if the firm goes bankrupt in the short term.\textsuperscript{43}

Revenue generation might include evaluating existing products, price-cuts or raises, and marketing expenditure strategies to drive up demand.\textsuperscript{44} Cost reduction might include concentrated input and resource cuts where the firm is operationally weak.\textsuperscript{45} For example, J. Kang and A. Shivdasani in the Journal of Financial Economics report Japanese firms in distress that cut costs through layoffs improve their operating income to assets significantly.\textsuperscript{46} Operating-asset reduction includes business-unit sales

\begin{flushright}
\textsuperscript{41} Ibid, 197.
\textsuperscript{42} Ibid, 185.
\textsuperscript{44} Ibid., 19–31.
\end{flushright}
and closures. It also includes consolidation of fixed assets such as PP&E and reduction in short-term assets such as inventory.\textsuperscript{47}

2. Financial Restructuring

This lever aims to redesign the firm’s capital structure through both equity and debt strategies. Equity strategies include dividend cuts or removals, and equity issues such as public offerings. Debt strategies include the renegotiation of debt terms such as interest or principal reductions, maturity extensions, and debt-equity swaps.\textsuperscript{48} Ultimately, improving liquidity and relieving interest costs and debt repayments are the primary objectives in restructuring financial assets.\textsuperscript{49}

3. Asset Restructuring

Asset restructuring is comprised of asset investment and divestment. This lever evaluates the firm as a strategic portfolio of business units.\textsuperscript{50} Firms close or sell underperforming businesses or those that deviate from their core value proposition; acquire companies that strengthen the core business; or form strategic alliances, joint ventures and licensing agreements.\textsuperscript{51}

Asset investment is both the internal capital expenditure and external acquisition behavior of firms. Capital expenditure includes the building of new plants and equipment, or implementing new


technological processes. Acquisition behavior has to be managed carefully to fit the core competency of the business and aim for long-term profit potential. Typically, firms that are not in financial distress yet exhibit poor financial performance tend to act acquisitively. The primary objective of asset investment is to improve productivity, long-term performance and achieve competitive advantage. Since asset investment generates cash outflow to achieve its objective, it is crucial that these investments are only taken as a survival and recovery strategy.

Asset divestment or reduction is imperative when the firm’s health is weak. Asset reduction includes divesting non-profit generating assets, divisions, and subsidiaries. S. Slatter in Corporate Recovery: Successful Turnaround Strategies and Their Implementation reports that divestment of subsidiaries is a turnaround strategy frequently implemented by a majority of firms.

Moreover, the stress of the situation presents managers with an opportunity to make hard choices that, during good times, would be too sensitive to approach. Business units or personnel with historical and political significance that no longer create value, or will not create value in the future, can be cut off for the sake of saving the company. As Sull highlights in Seizing the Upside of a Downturn, “managers can harness a downturn to renew a sense of urgency, justify unpopular decisions, and overcome

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complacency.”⁵⁷ The opportunity to restructure the firm for long-term success through asset restructuring, organizational changes and changing incentive structures is a strategic benefit to the firm.

4. Managerial Restructuring

This lever is quoted by many experts as a precondition for successful turnarounds.⁵⁸ Managerial restructuring is defined fundamentally as changing one top management team for another. Banks and creditors will not continue financial support unless they have confidence in the management team. S. Slatter reports in Corporate Recovery: Successful Turnaround Strategies and Their Implementation that when top management changes, it is a signal to bankers, investors, and employees that “something positive is being done to improve the firm’s performance, even though the cause of poor performance may have been beyond management’s control.”⁵⁹

3.2 Industry Best Practices

Turnaround specialists utilize many of the levers observed above. Examining these levers, in conjunction with the academic research, helped us understand the significant steps taken by investment banks that survived the 2008 crisis. As a practical example we will look at best practices from the South African firm Corporate Renewal Specialist Turnaround Management (CRS) and the McKinsey’s Recovery and Transformation Services (RTS) division. We chose these firms for their track record of success in implementing turnarounds, and because each firm openly publishes insights into their process. Additionally, we were able to conduct interviews with McKinsey turnaround specialists.

⁵⁹ Ibid.
Both RTS and CRS adhere to multi-phase plans, with multiple steps at each phase. Yet, each turnaround scenario is unique and requires wisdom from experienced managers to know which levers to engage and at what time. We will look at each firm separately.

CRS

CRS breaks down their process into phases that address the levers needed to turnaround a failing enterprise. CRS’ process closely aligns with what academic research shows to be statistically significant in successful turnaround cases. We will provide a high level overview of the main levers in their process and examine each step briefly. The three main steps are:

1. Stabilization
2. Recapitalization and Funding
3. Fixing

1. Stabilization

This is most akin to “Operational Restructuring” found above, and can be translated as “stop the bleeding.” CRS comes in as an outside team and firstly assesses and prioritizes the problem areas by identifying the root cause of the firm’s decline. Often this means removing the existing management team and replacing leadership with CRS members, an outside hire, or a reduced version of the old management team. Secondly, they emphasize cash control. This entails strict spending controls,

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mitigating areas of unsustainable costs, cash generation, and cash conservation. These efforts attempt to reintroduce a sense of normalcy while ensuring the failing business is in line with fiduciary and legal compliance.\textsuperscript{61}

2. Recapitalization and Funding

This step encompasses the “Financial Restructuring” lever. CRS examines the capital structure of the firm and ensures the balance sheet returns to solvency. They make sure that all short-term working capital and interest payments can be met; that fees are available for their professional service; and that cash is available to invest in the proper system improvements. Funds are injected where necessary through debt or equity financing, often raised through private equity firms or banks.\textsuperscript{62}

3. Fixing

This is the “Asset” and “Managerial Restructuring” phase. The strategy, operations, and personnel chart are examined for long-term competitiveness. CRS works to define product/market strategies, to redesign operational systems for efficiency gains, and to redesign organizational charts.

The leadership of the turnaround team is prioritized throughout the process. The team enters into a situation filled with uncertainty and tension, and must secure the buy-in of key stakeholders within the troubled firm. Additionally, proper stakeholder management, identifying different parties and their interest, is key to proper project execution. In short, turnaround leadership teams replace existing

\textsuperscript{61} Ibid.
\textsuperscript{62} Ibid.
management, analyze the situation and execute the plan, and then transition leadership to a new team once the business is restored to stability. The time frame is usually 18 months to 3 years.63

McKinsey’s RTS

According to Doug Yakola, RTS' current Senior Partner, the first step to turnaround is acknowledging that the firm is in need of help.64 Most managers are stuck in ‘business as usual’ mentalities and do not objectively analyze their current state or the near term implications.65 If the leaders at the firm acknowledge their need of help, McKinsey has identified levers the firm could employ to regain profitability:

- Strategic
- Operational
- Managerial
- Financial66

These levers align with academic findings and CRS best practices. In addition to the levers, McKinsey identified statistically significant characteristics of successful turnaround cases. Elaborating on these characteristics will further highlight what investment banks did to survive the crisis. McKinsey’s findings were published in the 2010 white paper, “What Successful Transformations Share: McKinsey Global Survey Result.” Four main characteristics were identified:67

1. Set clear, aspirational goals

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63 Ibid.
65 Ibid.
2. Build a clear, collaborative structure

3. Maintain engagement and energy throughout the distressed firm

4. Strong leadership and capacity building

These steps tended to compliment and reinforce one another in the turnaround process and were most closely correlated with firm health in the long term. Each step is examined below.

1. Set Clear, Aspirational Goals

Firms often go into distress for lack of coherent strategy and vision. Turnaround specialists prioritize the firm’s top goals in simple, concise terms and set deadlines for achieving those goals. The deadlines force managers to critique their own plan and examine their processes for deficiencies if the goals are not met. \(^{69}\)

The goals should be simple financial metrics based on cash flow and, according to RTS, should focus on short-term wins to boost morale. \(^{70}\) Short-term wins often involve cutting costs by eliminating the need of an outside service provider or trimming down travel policies. \(^{71}\) Moreover, incentive structures should be reworked to reflect an employee’s ability to help the company turnaround. Managers can do this by setting performance metrics and an ‘all or nothing’ bonus for achieving the desired metric. \(^{72}\) This does

\(^{68}\) Ibid.


\(^{70}\) Ibid.

\(^{71}\) Ibid.

\(^{72}\) Ibid.
not mean that long-term goals negatively impact firms. Both are needed and must be communicated in a manner in which even the lowest level employee can understand.\footnote{Ibid.}

Moreover, an underused resource in turnaround situations is the board of directors. The board has the ability to look at the big picture objectively without getting caught up in the day-to-day details. Directors can hold management to tough measures that will save the company.\footnote{Ibid.}

2. **Build a Clear, Collaborative Structure**

Engaging as many employees as reasonably possible in the planning phase of the turnaround is key. Stakeholders from different functions and levels of the firm offer unique insight and inform the turnaround process.\footnote{Scott Keller, Mary Meaney, and Caroline Pung, “What successful transformations share: McKinsey Global Survey result”, March 2010. Accessed April 30, 2015.} Moreover, the more people that understand why the firm is struggling, the firm’s present capabilities, and what the firm needs to achieve, the more likely the firm will succeed in its turnaround.

In many instances, turnaround specialists pointed to the changes needed in the culture and mindsets of the firm as a precursor to any meaningful turnaround.\footnote{Ibid.} By engaging as many employees as possible and instilling a sense of urgency firms have a higher likelihood of a successful turnaround.

3. **Maintain Energy and Engagement Throughout the Distressed Firm**
Every turnaround needs to be treated like a crisis. Managers need to instill a sense of urgency so that large, sometimes painful, changes can be executed within the organization. Without a sense of urgency, incrementalism sets in and plans for large-scale change phase out as time elapses.

This sense of urgency requires strong leadership and clear communication through frequent meetings, emails, and memos. Often, managers who were part of the firm during its decline resist quick change. In such a case these managers need to be fired to illustrate the sincerity of the turnaround plans. Moreover, the sense of urgency and ownership needs to be transferred to front line employees. In doing so, every person executes their daily tasks in light of the overall turnaround plan.

4. Strong Leadership and Capacity Building

Leaders who shoulder the responsibility of a firm’s turnaround need to spend time and resources training employees to reflect the values and culture that will produce long-term success for the firm. This has a twofold effect in helping the firm’s turnaround. Firstly, employees gain the direct skills needed to execute their jobs more efficiently. Secondly, over time, employees embrace innovation and processes that stress continuous improvement more readily.

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81 Ibid.
82 Ibid.
All employees should be trained and be made aware of explicit changes in firm culture, but the best way to accelerate turnaround speed is to look for two types of people within the firm: those with institutional knowledge and high performers. The former hold invaluable insight into how the company actually works and will know best how change will affect everyone. The later, naturally drive the growth of the firm. These people should be identified and managers should spend time learning about their motivations to properly incentivize their efforts.

CRS and RTS provide a real time example of levers and characteristics found to be statistically significant in successful turnarounds. The next section will explore the internal changes investment banks underwent during the 2008 crisis to survive. Below is a glimpse into what happened on the inside of these ‘too big to fail’ institutions during -one of the most tumultuous events in modern history.

4  **Turnaround Patterns From Financial Service Interviews**

We interviewed a range of individuals to collect observations and qualitative insights on the turnaround strategies of financial services firms that were affected by the 2008 crisis. While we interviewed crisis management experts, insurance company professionals, financial service consultants, private equity leaders, academic professors knowledgeable on the subject, and investment bankers, the majority of our data ultimately was collected from investment bankers, and as a result facilitated the finer focus on investment banks for the analytic purpose of this paper. The trends we observed from the information provided by investment bankers were consistent with the insights found in review of our academic research. Three trends in particular stood out from our interviews:

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83 Ibid.
1. Interviewees reported that leadership within the banks spent time identifying the root cause of the problem before embarking on a course of action.

2. Consistent with the general findings highlighted from our review of academic research, a long-term investment positioning versus a short-term fire-fighting posture proved imperative in the recovery of firms from the crisis.

3. Effective communication and coordination on a firm-wide level were essential for turnaround success. While communication might be perceived as an obvious truth in leadership and business management, from our interviews, we observed the importance of effective communication as a turnaround lever.

We will look at each observation in turn.

1. Identify the root of the problems in the organization before taking action.

We provide two examples below in which Goldman Sachs identified the root of the problems in the organization before taking action. In the first example, Goldman was able to identify issues before the crisis, in the second example, the bank evaluated failures during the heat of the crisis. Regardless of the timing, it was the ability to identify the deepest causes of failure that allowed the company to design a course of action to overcome shortcomings in the bank.

Example 1: Risk Management Processes in Trading Divisions
While ultra-complex derivatives, toxic securities, and risk-taking behavior might on the surface be contributors to enormous declines in firm profit, according to our interview sources the failure occurred at a deeper point in the anatomical structure of profit generation: the risk management process. Ultimately, it was Goldman identifying the shortcomings in the risk management process that enabled it to create a solution, which we elaborate in the second section below.

First, sources at Goldman noted that risk processes across trading desks were too human-centric and lacked the technological capacity required to capture total risk in the system. The risks taken by teams on trading desks in the front office were controlled, monitored, and managed by managing directors and desk leaders, but the flow of risk information on a real-time basis stopped there. The back office failed to collect the real-time aggregate risk exposures across desks, and as a result, senior management were inadequately informed and less effective in managing strategic firm direction. Second, there was a lack of protection designed in the process against certain natural shortcomings that emerge from human behavior. For example, processes lacked appropriate disciplines or proper checks and balances to protect the firm against an individual actor’s propensity to follow the social herd into the emotional high of asset bubbles and compete against peers for high returns without fully understanding the complexity of their risk position. Additionally, the human tendency to relax monitoring and planning against left-tail events when times are good also was not properly protected against as the current processes were designed without the necessary technological checkpoints that would have assessed such statistical deviations.

Example 2: Asset Pricing Disciplines
Goldman Sachs is widely considered as the first firm to identify anomalies in their MBS derivative asset pricing.\(^8^5\) Goldman identified that the problem within its security positions was that the complexity of the securities themselves masked the true value of the securities. Through its mark-to-market pricing discipline, the company would sell positions in assets it owned on a daily basis to obtain the fair value. By doing so it was able to identify decreases in prices faster than competitors. In late 2006, Craig Broderick, the chief risk officer, and Lloyd Blankfein, CEO, began to see the makings of a crisis as investors took on more risk with complex securities.\(^8^6\) Broderick and Goldman leadership set up a series of trades that would allow them to secure cash flow in the event of a crisis by shorting positions on MBS and CDOs.\(^8^7\) In this case, the management identified the source of the problem before taking action.

2. Know how to concentrate key resources effectively. Take a medium to long-term, growth oriented approach: invest and invest wisely.

It is generally acknowledged that firms in a state of crisis have to meet their liquidity requirements through adequate working capital levels, interest coverage ratios, and short-term debt repayments to maintain their core operating activities. As C.W. Hofer rightly noted in the *Journal of Business Strategy* the first turnaround strategy implemented when firms face financial crises is operational restructuring to improve the financial health of the firm to avoid bankruptcy in the near term. However, implementing operational restructuring in a state of panic to avoid earnings declines in the short-term is not behavior consistent with successful stories. Rather, successful turnaround stories include management that assessed the long-term implications and the short-term alternative options. Once banks identified the root of the problems that drove deterioration in their value, the banks that recovered did not act in a


\(^{8^6}\) Ibid.

\(^{8^7}\) Ibid.
fire-fighting restructuring way, but in a way that ensured long-term growth. From our interviews, banks that survived invested in systems, client interactions, and labor capital; those who did not survive adopted a short-term investment view, which is reflected through their compensation model.

Example 1: Labor Capital Investments Versus Divestments

A few banks who struggled to recover implemented short-term decisions in their labor capital that were subtractive to performance. For example, unsuccessful banks cut compensation to junior employees to improve earnings in the short-term. Because of this, young talent was lost to other industries. Some sources in our interviews describe this segment of the banking labor structure as “the lifeblood of banks.” The drain of young talent ultimately caused shifts that in the medium to long-term affected productivity. Sources reported that had banks more strategically reduced compensation on a senior level, and allocated it on a junior level, labor productivity might have been better preserved. Similar sources commented that other banks that survived the crisis eliminated the traditional 2-year contracts and retained junior talent.

Example 2: Investments in Technology and Clients

Investing in assets, such as technology and clients, was a medium to long-term position that allowed banks to recover from the crisis. One interview source reported that Goldman Sachs spent financial resources during the crisis to build technologically-oriented risk processes and to increase client-facing interactions to secure relationships. He noted, while Goldman incurred costs in the short-term that might have decreased earnings, ultimately, it secured their position in the long-term. Bloomberg cites Goldman as investing “billions” of dollars into new systems and technologies, allocating a portion of
these billions into its proprietary trading database, SecDB, which tracks all trades made by the bank and assesses its total risk. Moreover, the company invested in the human capital necessary to evaluate the risk, communicate it, and act accordingly.

In short, interview sources noted that it was not the products that needed to be cut or even the culture that needed to change during the crisis. Rather, it was the need to invest financial resources to keep clients and to gain new clients even if it contributed to expenses that inhibited performance in the short-term. These were medium to long-term revenue generators and ultimately were imperative for emerging successfully against peers.

3. Leadership must be present and manage communication strategies effectively to enable efficient coordination of knowledge transfer and information flow.

A few sources in interviews commented that one contributor of division-wide profit generation during the crisis was the fluent coordination across teams. Below we provide two examples.

Example 1: Teams Cross-Sell and Share Information

Equity derivatives and high yield fixed income teams at Barclays were able to identify synergies in their client relationships when they shared knowledge stored in Client Relationship Management (CRM) systems. This allowed for greater cross-selling, which consolidated sales teams and reduced duplicate efforts. One source at Barclays noted that they had not shared this information before because compensation was usually tied to relationships on sales teams, which incentivized internal teams to act

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88 Ibid.
territorial. Coordination, knowledge transfer, and information flow were more effective and realized synergies for the firm once management changed compensation models to align incentives.

Example 2: Communication Disciplines at Goldman During the Crisis

Goldman Sachs was disciplined, even robust, in communication between senior executives, middle management, junior level professionals, and clients. Sources at Goldman Sachs noted that on a firm-wide level, teams were expected to maintain routine weekly and bi-weekly meetings. These provided senior leadership the visibility to more closely govern junior level daily decisions, and monitor irrational risk-taking behaviors of traders who feared lower returns would cost them their jobs.

Additionally, more frequent client meetings were scheduled even if this involved increasing travel costs. Goldman employees said trust between clients and the bank increased during the crisis because they were transparent about the short-term hit they would take but reassured them of their long-term profit motive.

5 Conclusion

Starting in late 2007, the U.S. financial system entered its worst crisis since WWII. Almost overnight, the largest banks, insurance companies, and mortgage lenders were liable to pay out on risky bets they made with extreme amounts of debt. The stock market plummeted and borrowing costs for the financial firms became unsustainable. The liquidity of the world’s financial system dried up. As the U.S. government stepped in to offer bailout money, managers scrambled to keep their firms solvent. Some businesses failed, some succeeded, but a majority suffered losses on their balance sheets and cash flow.
statements. We set out to discover what it took to survive the 2008 crisis: what turnaround strategies did investment banks employ to survive apart from government bailout money?

To answer the question, we reviewed empirical studies, examined best practices, and interviewed financial service industry professionals. We found that the surviving banks, specifically Goldman Sachs, executed a few key initiatives well. More importantly, these initiatives align with levers found to be empirically significant in academic research and accepted best practices by turnaround specialists. Goldman Sachs identified the root cause of the issue, invested in resources that would set them up for success despite the short-term financial distress, and communicated effectively to employees and clients.

Additionally, we conclude that, although there are levers to utilize in a turnaround situation, there are no set guidelines. Each lever is conceptually simple, but difficult to implement in the midst of financial and organizational turmoil. Moreover, each situation requires its own action plan and remedy. Much of the burden lies on the shoulders of managers and leaders to galvanize a struggling firm back on the path to profitability by executing insightful strategies efficiently and in a timely fashion. Our hope is that business leaders can glean insight from these findings and apply the appropriate levers to their businesses in times of distress. In doing so, they would be able to rebuild value - creating enterprises in the long-term for the betterment of their families and society.