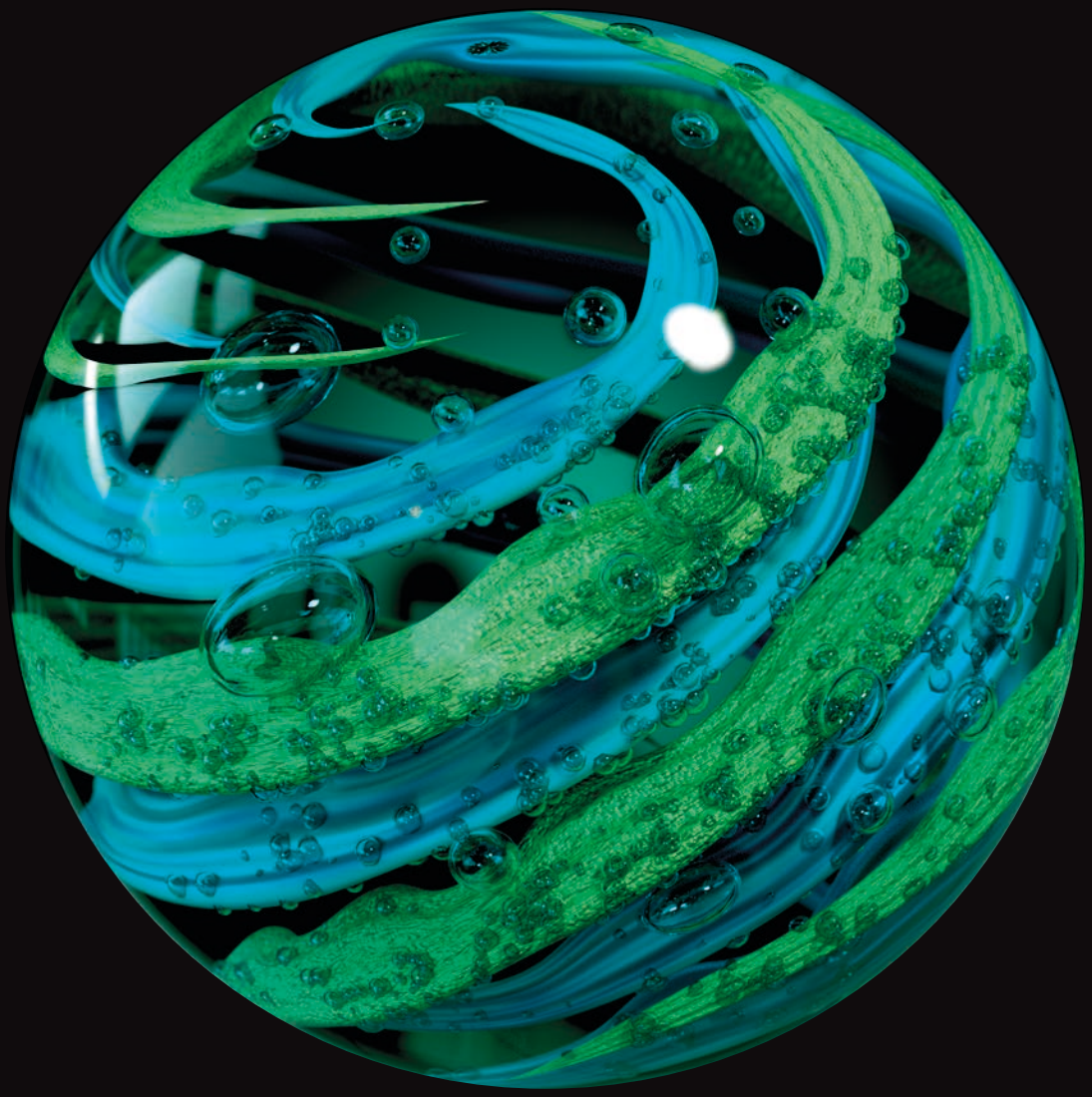
Deloitte.



Banking & Capital Markets

Capital & Performance Management in the 2020s

Realising value from transformation

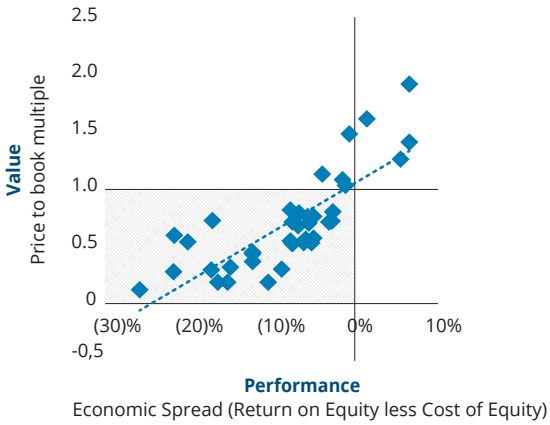
Contents

Background

Over ten years after the onset of the financial crisis, many banking and capital markets (BCM) firms are still struggling. With some stand-out exceptions in North America and Asia, firms are still unable to cover their capital costs, and are still being priced at well below their book values (Figure 1, shaded area). And there is now a global pandemic to deal with, on top of everything.

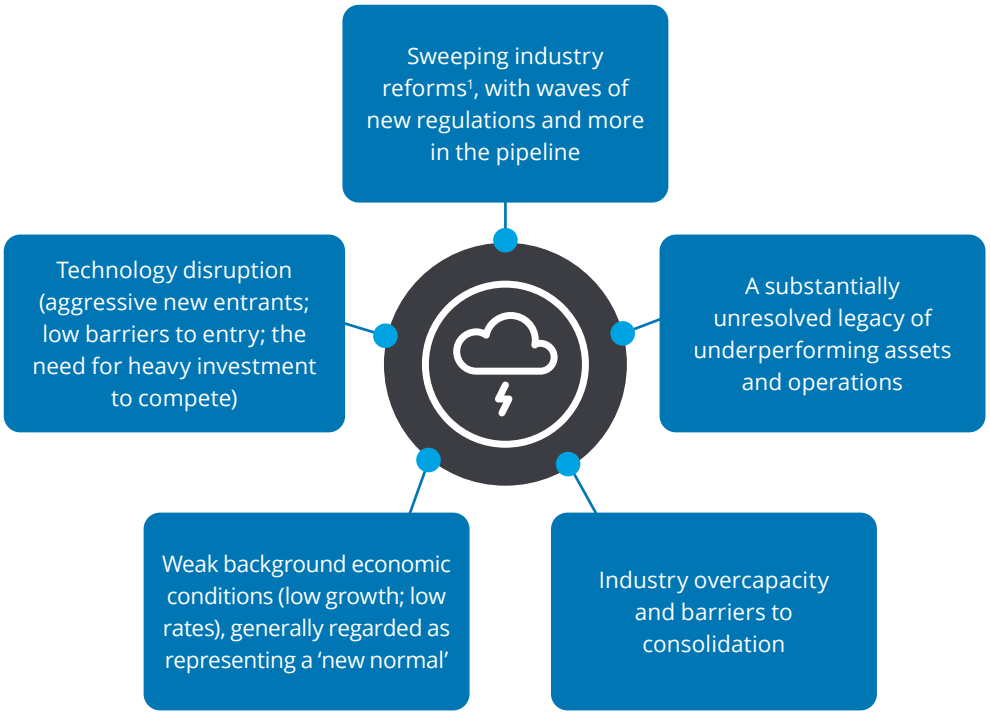
While there is nothing particularly significant about the start of a new decade, it still prompts the question of whether and how BCM firms (particularly in Europe) can finally restore themselves to a viable position, able sustainably to cover their capital costs and earn a re-rating from investors.

Figure 1. Bank values reflect their Economic Spread performance



Perfect storm

In some respects, their predicament should not be a surprise: BCM firms have endured a 'perfect storm' of challenges over the last decade, including:



The COVID-19 pandemic of course intensifies this storm enormously, posing a new major setback, if not an existential threat, as firms attempt to restore themselves to a sustainable position.

Together, these challenges have resulted, and will continue to result, in higher capital requirements (diluting capital returns), compressed profit margins, and weak share prices. With IFRS9, the capital impact of COVID-19 will hit soon, and hard.

1 Particularly the wholesale substitution of nominally free government support (the so-called 'implicit government guarantee', where taxpayers are expected to step in to avert bank failure) with nominally costly loss-absorbing finance and other resolution arrangements.

A better decade ahead?

Dwelling on these challenges could induce a belief that, once they have worked their way through, things will simply get better. They may get better, but not before some BCM firms have adapted themselves more proactively to the conditions and taken a firm competitive hold of their markets[2]. And meanwhile, the lesson from the 2010s is that improvements in the economic and trading environment are likely to remain slow, with frequent setbacks[3].

COVID-19 – a preliminary prognosis

BCM firms are now scrambling to deal with this major event, and all the new prudential measures put in place over the past decade will be tested severely in coming months. It is very hard to judge what the overall long term impact will be, at this stage, until there is a clearer indication of how long the pandemic will last and how serious the permanent economic damage will be. But we can be quite confident of three things:

1. BCM firms everywhere will take a major direct hit to their balance sheets and income statements through asset impairments and loss of revenue, together with whatever else they may choose or be required to do to support the wider economy
2. Policymakers will revise the criteria and parameters that define the resilience to be demonstrated by BCM firms, and conclude that capital and liquidity requirements should increase further
3. Firms will therefore find themselves with another major recapitalisation requirement and, if the scale of this exceeds what can be recovered through cuts to dividends or buybacks, they will need to make a fresh appeal to the market, underpinned by a prospectus in the usual way.

The ability to chart a credible path to a viable future will be essential.

Adaptation is therefore key to unlocking a viable, economically profitable future in an increasingly competitive and disrupted industry.

In broad terms this entails a fundamental shift in the strategic agenda, which has already gone through major convulsions since pre-crisis days (Figure 2).

In the 2010s the general emphasis was on recapitalisation and franchise redesign (firms deciding what they want to 'be'). In the 2020s the required emphasis is more on executing transformation ('becoming that thing') and realising value from it ('performing as that thing'). To be fair, some firms are already well on the way with their transformations (from the mid-2010s in some cases). But we hear plenty of CEOs, COOs and CFOs bemoaning the fact that, though the market may have loved their story, and though much progress may have been made on RWA reduction for example, the rewards in performance and price are not yet coming through.

Therefore, transformation must be guided by management disciplines to ensure that the 'value realisation' does not get lost along the way: disciplines that enable firms to deliver sustainable economic profits (where capital returns exceed capital costs) in markets where margins are tight and revenue and cost drivers (including capital cost drivers) are unstable. These disciplines include:

Focus and purpose: being clear about firms' core businesses, and how they fit together, relative to the wider industry ecosystem and evolving societal, economic, market and technology trends.

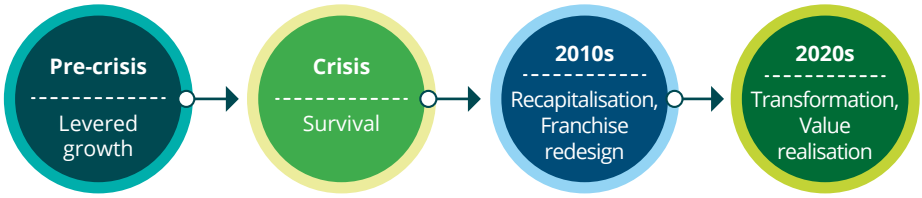
Client service innovation: maintaining a constant focus on evolving client needs, seeking ways to meet these through new offerings, and/or delivering existing offerings in new innovative ways, particularly through technology.

Cost leadership: being creative and vigilant on cost, to restore and maintain operating profitability in the face of weaker revenue growth, competitive price pressure and market price transparency[4].

Capital efficiency: doing all the above in a way that makes best use of available capital resources – within evolving regulatory parameters – while generating satisfactory residual value for equity capital providers.

This clearly has wide ranging implications for BCM leaders, across the board, particularly CEOs, COOs, CFOs, CROs and Divisional Heads, together with their functional delegates in Strategy, Technology, Planning, Investor Relations, Regulatory Relations, Treasury and Capital Management.

Figure 2. BCM firms have shifted their strategic agendas through turbulent times



2 In the US, where most progress is evident, a rump of BCM firms is still being left behind by the leaders.
3 The announcement in January 2020 that six Eurozone banks have failed the latest ECB stress tests – up from one the previous year – underscores this point.
4 We call it cost leadership rather than cost reduction because, for many, this is about a radical reengineering of the whole business model – embracing new technologies and alliances, including FinTech – as opposed to doing the same things a bit cheaper

Capital has a crucial part to play

Of these disciplines, capital efficiency has a special significance. Capital is the *instrument* through which much of the post-crisis reform agenda has been implemented (and is thus the 'commodity' whose scarcity and cost has upended industry economics[5]). It is also the *currency* whose internal allocation and investment drives the redirection of a firm's strategy and the transformation of its products, services and operations. And finally it is the *lens* through which the solvency, viability and performance of the firm, and its constituent parts, is appraised by all concerned.

It follows that Capital & Performance Management has a crucial part to play in restoring BCM firms to viability – enabling them to realise value from transformation (Figure 3). We believe it falls to CFOs, in particular, to take a lead on this.

Of course capital has always been important, so why the need to adapt now? The answer lies in the point that the economics of banking have been upended through, in particular, capital reforms.

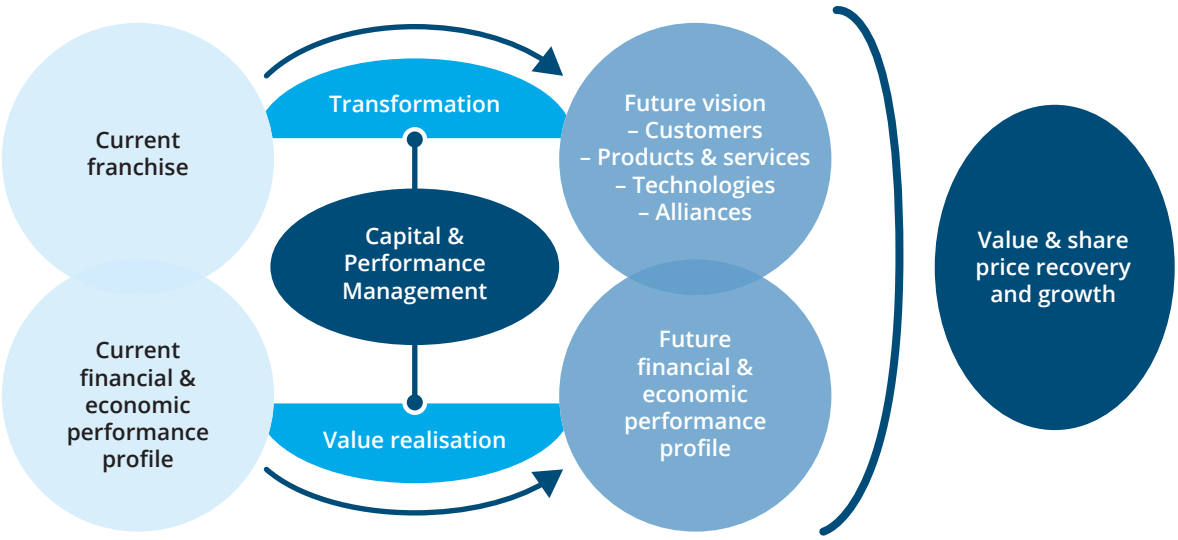
The key changes stem from the effective removal of government support (the 'implicit government guarantee') and the forced adjustment to firms' capital structures effectively to fill this gap. As well as resulting in structurally higher economic costs, this shift has had further repercussions, including:

- The need to operate within stringent and complex prudential regulations, covering not just old-fashioned equity, but also other loss-absorbing capital (under TLAC and MREL requirements), long term stable funding (NSFR), and liquidity (LCR).
- Adjustments to the economic cost of these various tiers of capital as they (collectively) take on more risk and (respectively) take varying shares of that risk.
- The heightened sensitivity of *equity* capital costs, therefore, both to underlying business risks (Beta) and capital structures (Leverage), both overall and – importantly – across business units.
- The heightened sensitivity of firms' equity *values*, therefore, to the spread between their equity capital returns and their equity capital costs – their Economic Spreads[6].

This has profound implications for BCM firms, not just in terms of how they shape and finance their businesses overall, but also how they manage capital and performance internally, i.e. how they:

- Optimise the allocation of scarce capital resources across competing claims.
- Measure actual and prospective business unit performance, through a capital lens.
- Represent that performance to investors and other stakeholders.

Figure 3. Capital & Performance Management is crucial to realising value from transformation



5 In this sense, it is arguably the driving force behind the whole transformation imperative.
6 See also Figure 1. Research shows that firms' Price-to-Book (PB) ratios now correlate consistently better with their Economic Spreads (ES) than with their headline returns (RoE). This stands to reason when Economic Spreads are tighter and underlying capital costs are more differentiated and more volatile.

New Capital & Performance Management disciplines

Against this background, it is clear that Capital & Performance Management disciplines are in many respects outmoded and in need of renewal. We focus on three key areas:

1. Portfolio management – Pre-crisis, this was positioned as applying the principles of Modern Portfolio Theory (MPT) to firms' balance sheets, as they sought to optimise risk-return performance. It now faces a proliferation of practical complexities and constraints, from *regulation* (given the new capital, funding and liquidity requirements), to *markets* (given the intensifying competition for a volatile and barely growing aggregate market 'wallet') and *franchise dynamics* (given the importance, in light of that competition, of creating and exploiting franchise synergies from brand to operations). It is no longer (if it ever was) a simple matter of optimising risk-return by varying portfolio mix, as MPT would have it.

2. Performance measurement – The legacy approach of using *risk* measures to drive business unit capital allocations (against a common, static hurdle rate) has been disrupted by the post-crisis, port-reform dominance of *regulation* in setting firms' overall capital requirements. Most firms have now responded by allocating capital internally on this basis as well. Since regulatory capital is a function of many things besides *pure economic risk* (stress tests, for example), and also has the effect of changing business unit *leverage* (often quite dramatically), this has the potential to distort performance measures and lead to poor resource allocation, investment and pricing decisions.

It is therefore necessary to reconfigure how economic performance is measured to take account of these changes, for example, by making compensating adjustments to the cost of allocated capital, and corresponding hurdle rates.

Meanwhile, as firms continue to commit themselves to headline RoE targets, parallel (economic and financial/regulatory) measurement systems need to be in place, with clear decisions rules for situations where those measures give conflicting signals.

3. Value creation & realisation – Investors are clearly taking a different view of BCM firms, as the perceived pre-crisis value drivers of growth and leverage are no longer on offer, and as the 'new normal' realities of higher financing costs and tighter operating margins take hold. Although there remains a lot of analyst and industry focus on headline RoE recovery, as indicated before (see Figure 1 and footnote 6) investors are paying increasing attention to Economic Spreads. Therefore, in order to realise value from their transformations, firms need to engage with investors[7] *in these terms* about how their strategies and transformations will restore positive, sustainable, results. This requirement has a special significance now given the recapitalisation that will have to follow COVID-19.

These developments are summarised in Figure 4 overleaf.

It is clear that Capital & Performance Management disciplines are outmoded and in need of renewal.

7 And supervisors, incidentally, who are taking an increasing interest in long term viability

New Capital & Performance Management disciplines (contd)

Figure 4. Capital & Performance Management disciplines are outmoded in three key areas

	1 Portfolio management	2 Performance measurement	3 Value creation & realisation
Legacy Orthodoxy	**Abstract risk-return optimisation** • Unconstrained • Crude treatment of franchise dynamics	**Risk-adjusted performance measurement** • **Risk-based** capital allocation • Common, static hurdle rate	**Value management by proxy indicator** • RoE, Leverage • Growth
New realities/ disruptions	**Regulatory, commercial & operational complexity** • Multiple, overlapping prudential constraints (capital, funding, liquidity, risk appetite) • Market constraints (competition, specialisation, increased price elasticity) • Franchise constraints (brand, financial, commercial & operational interdependencies) • Multiple goals & horizons • Shifting portfolio dynamics with shifting landscape (regulatory, commercial, operational)	**Industry reforms** • **Regulation-based** capital allocation • Distorted performance metrics • Implicit government guarantee subsidy removed – Increased capital cost – Increased capital cost *sensitivity* – Increased capital cost *complexity & disparity* • Narrower, more volatile Economic Spreads (capital returns and capital costs disrupted)	**'New normal' economics** • Leverage no longer allowed, or as highly valued • Emphasis on 'right-sizing' • Widespread re-rating, reflecting: – Long term cost of industry reforms – Low growth – Increased competition • Increased focus on Economic Spreads (RoE-CoE) alongside headline returns and growth • Increased disparity and volatility in values, prices and multiples reflecting industry disruption and uncertainty
Required developments	• *Sophisticated, dynamic optimisation of scarce resources* • *Full account taken of complex franchise dynamics*	• *Reemphasis on **adapted** economic performance measures (Economic Spread; Economic Profit) alongside financial measures*	• *Management disciplines to drive **sustained** economic profitability* • *Clear engagement with investors and supervisors, **in these terms***
New disciplines	**Dynamic Capital Optimisation**	**Economic Performance Measurement**	**Integrated Value Management**

Conclusion

To realise value from transformation in the 2020s, BCM firms need to apply the following key Capital & Performance Management disciplines:

Figure 5. New Capital & Performance Management disciplines

Dynamic Capital Optimisation

Optimising equity returns, through changes in business and capital mix, subject to prudential, market and franchise constraints

Optimising business responsiveness to external market conditions and internal portfolio dynamics, through continuous reallocation and/or repricing of Capital resources and continuous recalibration of targets and limits

Economic Performance Measurement

Measuring prospective and actual business performance according to economic value principles and empirical market price data

Adopting Economic Spread (ES = RoE-CoE) and Economic Profit (EP = ES*Equity) as key metrics and steering principles, alongside headline financial (RoE) and prudential (Capital ratio; rating; risk appetite) criteria

Integrated Value Management

Managing strategic, financial, commercial and operational business levers to maximise enterprise value and share price, through their expected impact on current and future economic profitability (ES; EP)

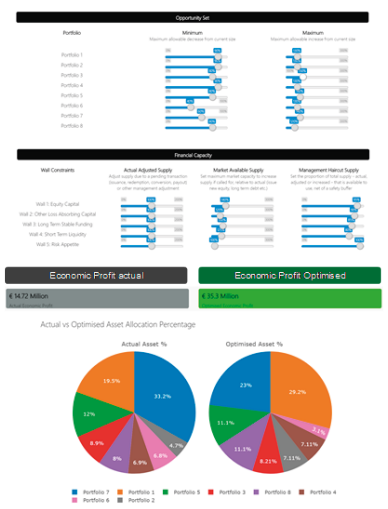
Realising value through proactive engagement in these terms with institutional investors, equity analysts, rating agencies and supervisors

Through our deep market experience and expertise in Capital and Performance Management (alongside related capabilities in strategy, corporate finance, risk and regulation), and with the aid of dedicated frameworks, methodologies and tools (Figure 6), we are helping BCM firms across Europe and beyond to realise value from their transformations.

Figure 6. Deloitte Capital & Performance Management frameworks, methodologies and tools

Capital Optimisation Model — DeCOM

An interactive multi-factor optimisation model to indicate performance improvement opportunities through changes in business and capital mix

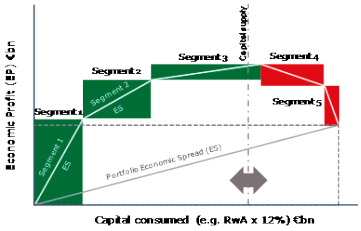


Market-Consistent Economic Profit — MCEP

An economic performance measurement methodology where bank and business unit CoE hurdle rates are dynamically calibrated to market values (beta) and leverage

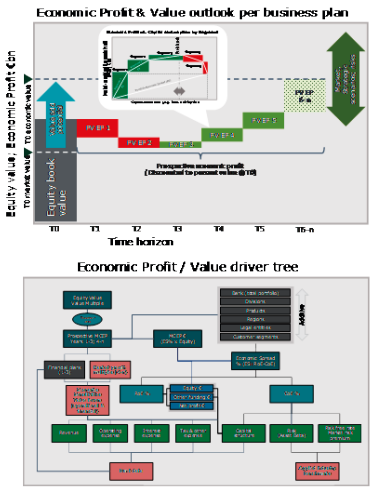
Segmental Performance

Business segment	Attributed Equity (€m)	Leverage A/E	RoE %	CoE %	ES %	EP (€m)
IB - Advisory and origination	1,289	1.6	12.2%	7.7%	4.50%	58
Private banking	3,652	11	11.2%	8.9%	2.30%	84
Corporate banking	24,667	11.7	8.3%	6.8%	1.50%	370
Asset management	1,846	3.1	11.7%	13.0%	-1.30%	-24
IB - Global markets	9,872	16.8	6.7%	11.4%	-4.70%	-464
Retail banking	20,829	15.2	8.5%	12.6%	-4.10%	-854
Total	62,155	13.2	8.5%	9.8%	-1.34%	-830



Integrated Value Framework — DIVal

A Multi-period strategic planning and value management framework, based on prospective Economic Profit (MCEP), and linked to enterprise value and share price



Following this article, there will be a series of publications that will expand on the various topics we have raised here.

Contacts

For further information in relation to this topic, please contact the following Deloitte industry and subject matter experts.

Paul Freeman
paufreeman@deloitte.co.uk
+44 20 7007 7495

David Myers
damyers@deloitte.co.uk
+44 20 7303 5609

Miles Kennedy
mkkennedy@deloitte.co.uk
+44 20 7007 2641

Richard Kibble
rkibble@deloitte.co.uk
+44 20 7303 6761

Notes

Deloitte.

Designed by CoRe Creative Services. RITM0408174