OLIVER WYMAN

Financial Services

FINANCIAL RESOURCE MANAGEMENT

# ADDING 5% TO ROE

## HOW BANKS CAN DO MORE WITH LESS

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# INTRODUCTION

In a world of unlimited abundance, there are no opportunity costs and hence no trade-offs. Any use of resources is as good as any other. People raised in such a world would be ill-prepared for life if, to their unpleasant surprise, they awoke one day to find themselves in the real world of scarcity.

The credit crunch, which grew into the global financial crisis, was such a rude awakening for bankers. They were rapidly transported from a world of abundance to one of extreme scarcity. Most banks would have failed if not for emergency funding and recapitalisation from governments. Even now, European banks are being nursed back into reality with the help of trillions of Euros of central bank funding provided at a massive discount to the market rate.

This will not go on forever. Equity capital is already scarce and expensive and, sooner or later, central bankers will need to stop increasing the monetary base or risk hyper-inflation. In short, banks are entering a world of scarcity but with business models developed on an assumption of abundance.

And regulation is exacerbating the problem. Basel III is creating a European shortfall of €2.7 TN in stable funding and well over €100 BN in common equity, the initial reaction to which has been a wave of deleveraging. While a necessary short-term step, this will not be sufficient in the long-term. Hurried deleveraging and minor tweaks to business models will not fill the shortfalls in a sustainable way – the financial services industry, and banks themselves, will have to change.

As structured today, the financial service industry is riddled with inefficiency. Banking's stable funding shortfall is unevenly distributed, reducing to "only" €1 TN when banks with a deficit are netted against those with a surplus[1]. At the same time that banks are grappling with this aggregate shortfall, the insurance industry is sitting on a significant surplus and seeking to deploy it more actively[2]. In fact, across seven of the world's major economies there is no structural mismatch in medium-and long-term assets and liabilities. Household savings more than cover corporate and government financing needs[3]. It is inefficiencies in the industry itself that are failing to match supply and demand.

On top of the industry-wide issues, banks themselves are inefficient. Systems are poor, processes complex and incentives misaligned to strategy. Banks also undertake many tasks where they have no competitive advantage.

Banks must learn to squeeze all possible profit from the scarce financial resources now at their disposal, or lose out to new entrants who will. We see several parallels with other industries that have been through similar seismic challenges, pharmaceuticals, automotives and airlines amongst them. Experience shows that the journey will be long and difficult - and we should expect notable casualties along the way.

1 *The State of European Bank Funding*, Oliver Wyman, November 2011.
2 *The €200 Billion Opportunity: Why Insurers Should Lend More*, Oliver Wyman, June 2012.
3 *The Real Financial Crisis: Why Financial Intermediation is Failing*, OliverWyman, March 2012.

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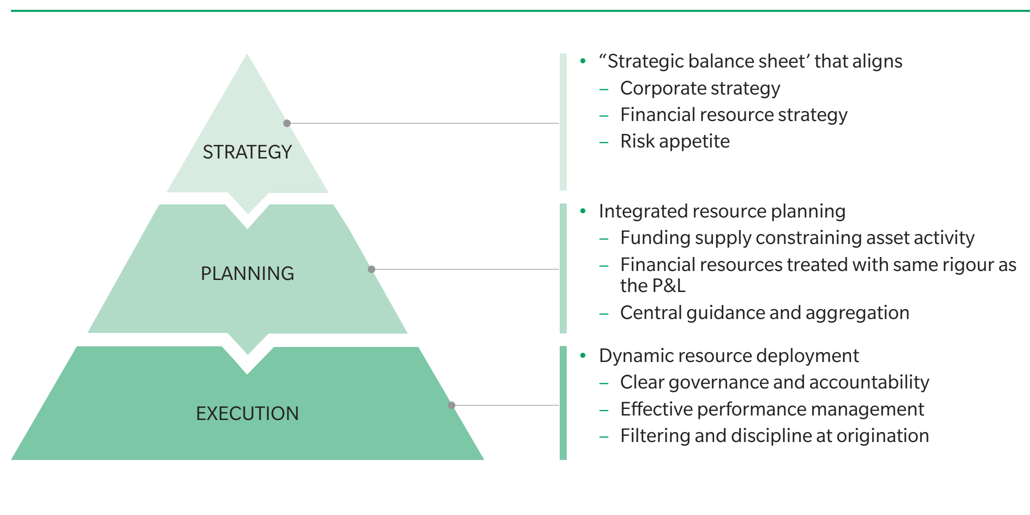
Things must change. Our experience indicates an extra 5% of Return on Equity (RoE) is available to banks that improve their financial resource management. This Oliver Wyman Perspective explains how.

## WHAT IS FINANCIAL RESOURCE MANAGEMENT?

Pared down to the basics, running a business involves decisions at three levels: setting a strategy, forming a business plan and executing the plan. For a bank, many complex and interconnected issues must be considered at each level. Historically, management have not been adequately focussed on financial resources anywhere in this hierarchy and they have failed to understand how decisions taken at one level will affect decisions elsewhere in the pyramid. Businesses have been empowered to optimise their own performance, under the assumption that what is good for them will be good for the group.

Banks must now adapt to an absolute constraint in financial resources. This will include a more disciplined top-down approach for their rationing (businesses will no longer be left to create largely independent plans). It will include a coherent framework that cascades group strategy to front office execution and it will be supported by stronger central command and control than has been the norm.




We now explain how banks need to improve.

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## CLARITY OF STRATEGY

Banks have frequently failed to account for financial resources in their strategic thinking. Financial resource strategy has been an unconsidered consequence of a corporate strategy, which are often little more than the aggregation of independently set business line strategies. The corporate centre has failed to consider up front how the parts will combine into a coherent aggregate balance sheet.

At best this approach is inefficient, leading to last-minute tactical fixes as management realises the "whole" fails to deliver the necessary returns or consumes too many financial resources. At worst it is calamitous, resulting in a systematic reliance on external markets to plug the gaps. Prior to 2007, such strategic thoughtlessness led many banks to rely excessively on short-term wholesale funding, with consequences that are now all too familiar.

The typical approach to strategy formation needs to change.

- **Financial resource strategy** needs to be developed through a review of the availability and attractiveness of all capital and funding sources. Future funding trends (for example, the impact of bail-in uncertainty on the senior unsecured debt market) must be considered, as well as the interplay between different tranches of the balance sheet (for example, the impact of encumbrance on resolvability and capital add-ons). Asset and liability driven businesses should be "paired" to maximise the balance sheet's efficiency and new sources of funding investigated – for example, can banks move into the annuities business as a corollary for the insurance industry's move into direct lending?
- **Corporate strategy** should concentrate on core markets and customers – where returns can be maximised through competitive advantages. The expected evolution of both asset and liability markets should be combined with economic profit pool analysis to highlight pockets of maximum future potential and provide a focus for deleveraging decisions. A consistent frame of reference should be used to assess the diverse opportunities found across a banking group
- **Risk appetite** must balance risk and return ambitions. Financial strength may well lead to a better rating and cheaper and more plentiful funding, but beyond a tipping point costs outweigh returns. The chase for returns needs to be dampened to avoid building hidden or excess risks. In short, risk appetite implications, including target ratios and balance sheet term structures and encumbrance levels, need to be an integral part from start to finish of the exercise.

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Including financial resources from the outset of the strategy process will have a material influence on the outcome. The bottom line implications are clear when one considers that a typical spread between the cost of retail and unsecured wholesale funding is over 100 bps (depending upon product this can exceed 300bps), and the spread between secured and unsecured wholesale funding is often over 150 bps. Client experience indicates 200bps increases in RoE can be possible through clearer financial resource strategy and consideration of risk appetite implications.

The crisis will drive institutions to revisit the structure of their balance sheets sooner or later, even those who are well placed will be affected by the strategic moves of others. Balance sheets are like oil tankers – they can only change direction slowly. Any deleveraging decisions you take today need to be informed by a coherent view of a target future state. To ensure you are headed in the right direction, you need a strategic balance sheet.

## COHERENCE IN PLANNING

Planning at banks is typically a laboriously drawn–out bottom-up process that delivers a camel rather than the horse hoped for. It focuses on income, costs and, perhaps the financial resource constraint *du jour*, relyes on a maxim such as "no growth in regulatory capital usage". Financial resources are often aggregated only at the end. And, because businesses fail to understand the link between P&L and balance sheet drivers, the output is often incorrect.

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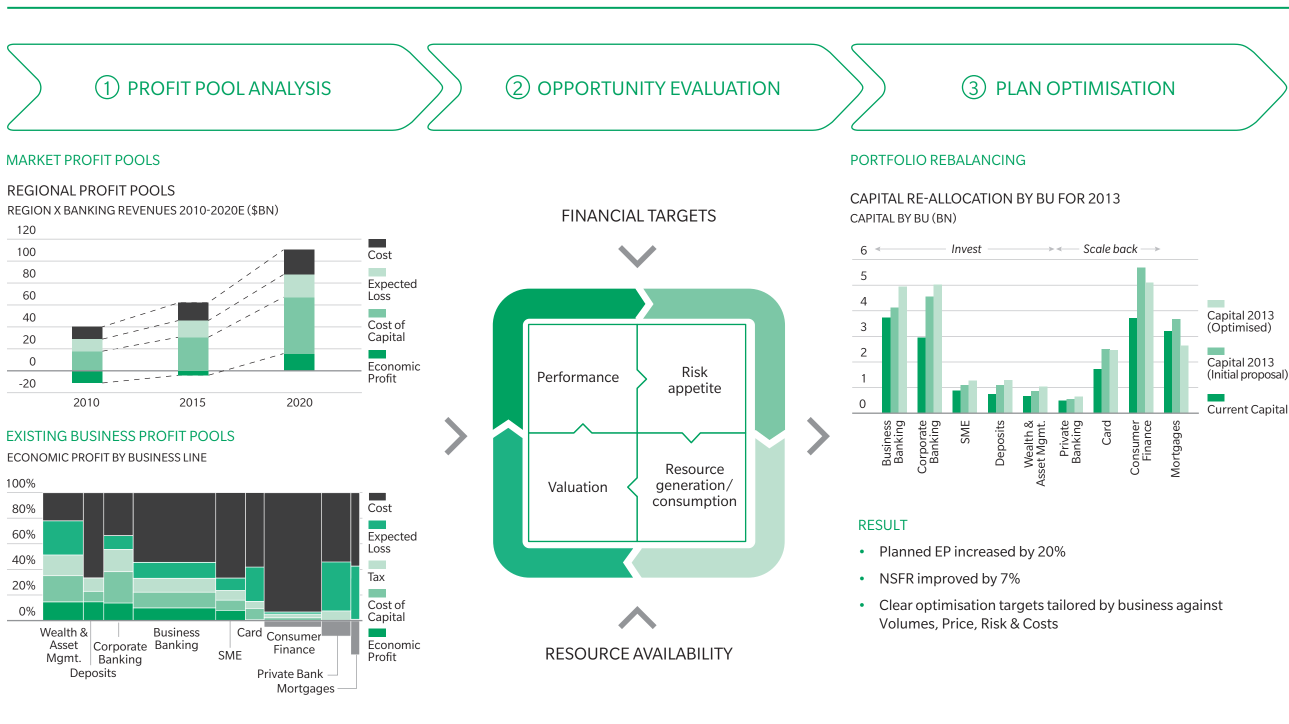
Processes frequently fail to effectively steer financial resources. Funding is directed to those who ask, even when significantly higher returns would be generated by alternative uses. A 2011 Oliver Wyman survey on strategic planning found that although 90% of respondents felt that their process allowed them to reallocate costs, only 60% felt they could effectively reallocate capital, and a paltry 30% funding.

Ineffective planning processes have been tolerated because, frankly, they haven't mattered. Exceeding the cost of resources was easy given their ready availability and low cost. As this is no longer the case, the upgrading of planning processes can no longer be delayed, with the allocation of financial resources being at the forefront throughout.

Integrated resource planning requires clear up-front guidance. It requires a consistent framework for the review of businesses, with risk and return implications analysed at every stage of the process. It requires a plan's implications for financial resources being modelled with the same rigour at its implications for the P&L. Importantly, it also requires a strong central team, with the analytical capability to rapidly aggregate and stress business plans to support the process, providing feedback and insight to the businesses as plans are formulated, rather than afterwards.

Integrated resource planning has a dramatic effect on performance. As an example, for one client an analysis of future profit pools was used to highlight areas of maximum potential. Opportunities were then assessed along consistent dimensions, including capital and funding consumption and generation. The result was a tilting of businesses plans that increased Economic Profit by almost 20% and Net Stable Funding Ratio by 7%.

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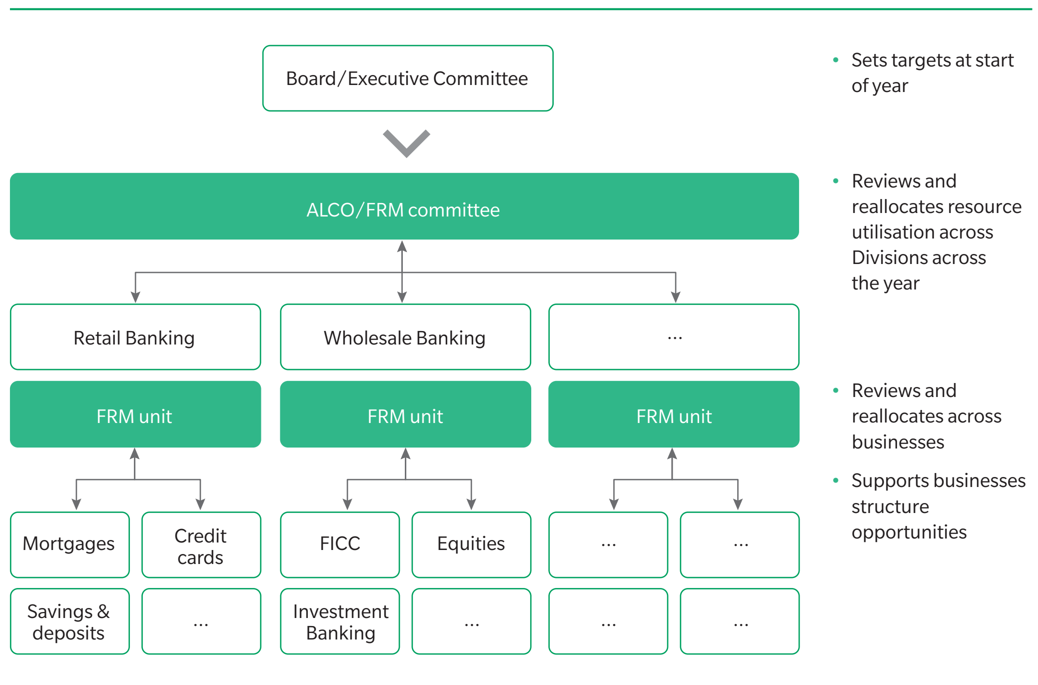
Of course, fancy analytics are worth nothing if management are not prepared and equipped to make reallocation decisions. Because such decisions can be difficult, the process needs to be transparent and the analysis sufficiently robust to diffuse political tensions – features missing from most of processes we have seen.

It is worth the effort to fix your planning process. Our experience leads us to believe that firms could improve RoE by over 200 bps through doing so, with only a relatively minor impact on their businesses.

## DISCIPLINE IN DEPLOYMENT

Plans alone do not guarantee success. Mechanisms are needed to steer the inflow – that is, to ensure transactions are structured and opportunities prioritised to generate the best returns. The organisation also needs to be nimble – reviewing performance, “shaking the tree” for capital and balance sheet, and redeploying resources mid-cycle as appropriate. Historically, many processes have failed to respond either quickly or adequately to circumstances or performance.

Processes need to be engrained throughout the organisation and performance should be regularly scrutinised and resources redistributed accordingly. Accountabilities need to be clear and the organisational structure must promote co-ordinated decision-making. Too often responsibility and objectives are blurred and processes informal, precluding effective decision making.



Forming a dedicated FRM unit (or modifying an ALCO's existing remit), reporting to the CFO or CEO, is an obvious first step. Its remit should be to review performance, resource allocations and consumption across major business units and to redeploy as appropriate.

The group process should then be mirrored across the businesses. FRM units should help the business to structure new opportunities, "scrub" existing business to optimise resource usage and scour their portfolio for opportunities to redeploy. We have helped several wholesale banks – for whom resource issues have been particularly acute – to develop these capabilities. While now common in wholesale banking, this discipline should become the norm across all firms and all business areas.

The FRM governance structure requires several tools to succeed. An agreed suite of performance measures must be identified (which may differ across businesses and geographies) and made transparent, and a consistent and rational charging structure must underpin things. Critically, MI must be robust, informative and timely across the organisation. This often requires an overhaul of report design and significant data quality improvement. Most importantly, it requires leadership: executives who understand the dynamics of different businesses and who are sufficiently tough to be able to take and enforce what can be unpopular decisions.

Quantifying the group-level impact of FRM "units" is obviously difficult. However, when one considers that simply taking a more disciplined approach to scouring risk-weighted asset drivers and implementing the resultant remedial actions can lead to a potential 100bps increase in RoE, the size of the potential prize becomes clear.

## WHY ISN'T THIS EASY?

Designing a strategic balance sheet is a well-defined problem. It is relatively simple to undertake once management have agreed that there are no sacred cows and have tasked the appropriate areas to deliver. The challenge is in making this more than a paper tiger.

The scale of the task will depend upon existing culture and capabilities. Beyond specialist areas financial resources are not well understood. We are often amazed when working with senior management on mission critical capital or liquidity assignments, that how few in the organisation outside of the project team realise there is even an issue. Often businesses remain devoted to activities that significantly compound the problem.

The analytic capability to run an effective financial resource focussed planning process is difficult to achieve. Finance and Risk system hierarchies often differ, meaning that even generating risk-adjusted returns information in the first place is a challenge. Models at group and business level are needed that include all key risk drivers, are based on consistent

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assumptions and produce the suite of KPIs needed to assess what can be very different businesses on a like for like basis. Reality is more often a multitude of independently developed spreadsheets providing a jumble of information.

Financial resources need to be treated with the same rigour as costs. Businesses and individuals must be transparently charged for their use. This usually requires both risk analytics and data systems to be upgraded. Correcting common errors in FTP methodologies, for example, can change the measured RoE on a mortgage business by as much as 100bps (and failing to align the FTP to the group's actual funding strategy can result in significant losses).

Most importantly, people will need to adapt. New capabilities will be needed and many will have to learn to operate outside of their traditional comfort zone[4]. Business managers will need to be encouraged to think in new ways, especially about their performance, recognising that revenue and costs are not the whole story. Importantly, CFOs and Treasurers will need to ensure they play a leading role in strategic processes[5] as more onus will be placed on the corporate centre for business steering. Finally, existing siloes across the organisation will need to be broken – front office, finance, risk and treasury professionals, who have very different motivations, personalities and communication styles will have to work effectively together.

## DO I HAVE TO DO THIS NOW?

Capital and funding effectiveness is now the key driver of performance. To achieve returns anywhere near pre-crisis levels, banks need to wring every ounce of performance from their precious financial resources. If they do, the 500 bps uplift in RoE we have described is a realistic goal for complex institutions.

For a few institutions, improving financial resource management will not be a significant task. Their business models are already fit for this purpose, with financial resources engrained in corporate processes and culture. For most, however, it will require a major change – of capabilities and of culture. These things do not happen overnight.

If you are a bank executive today, you are managing through a time of unprecedented challenge. Regulations and regulators are changing; you are being forced to deleverage while maintaining performance; capital and funding requirements are substantially increasing and debt continues to fall due. Geographic and legal entity issues, which were previously unimportant, are creating significant inefficiencies. If this were not enough, you lead an unhappy workforce battered by the public perception of the industry and enforced compensation changes. Why add to this list today with another initiative?

4 *Finance Capabilities; Doing more with less – The Role of People*, Oliver Wyman, February 2012.
5 *The CFO role revisited*, Oliver Wyman, June 2011.

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- **These capabilities are essential**. You need to raise performance and these capabilities can add percentage points onto RoE. New entrants, unencumbered by the baggage banks carry today, can develop more efficent businesses from scratch. Consider the challenge faced by the US automotive industry in the 1970's – today's Toyota Prius bears only minimal resemblance to a 1970's Chrysler Cordoba.
- **The clock is ticking**. Implementing a target balance sheet will take time. Planning processes fit within an annual cycle and changing culture and behaviours is a lengthy process. When the LTRO matures in 2014, over €1 TN of funding will need to be replaced. You need to know where you are taking your organisation to get there first.
- **If not now, then when?** Regulations are already forcing you to fundamentally change your organisation. Your people understand that the way they have done things has to change. The investment required is minimal in light of the €0.5 BN+ average spend of a Tier 1 bank for crisis driven regulatory reform. Returns will be significant and lasting.

None of what we have described is mandated by regulation. Rather, it is something that can link many of your current compliance initiatives to drive business value. Unless you are one of the very lucky few, doing nothing is not an option. If your goal is to make sustainable double digit returns, you will need to do more with less. Your bank needs financial resource management at its core.

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