A New Dawn?
Restoring Profitability while
Rebuilding Capital
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Operating and competing with a more restricted balance sheet

The Independent Commission on Banking’s proposals on loss absorbency will intensify the already strong regulatory pressures on banks’ capital, liquidity, funding and leverage. And the introduction of ring-fencing will make the task of managing these pressures more complex, by requiring universal banks to address them separately for their ring-fenced and non-ring-fenced operations. The overall impact will be to raise the costs of doing business still further, while simultaneously restricting banks’ opportunities to pursue revenue growth.

In response, universal banks need to find ways to mitigate the costs of regulatory developments – particularly on their non-ring-fenced operations – while also identifying opportunities to restore profitability by increasing existing revenue streams or generating new ones. In our view, the optimal approach will involve understanding the cost of capital accurately to serve clients and price correctly, managing risk-weighted assets (RWAs) to maximise risk-adjusted returns, and ensuring an efficient cost base to underpin operations. Banks that take these steps at an early stage will be well positioned to achieve high performance in the capital-constrained post-ICB world.
In combination, it is estimated that the capital impacts of the ICB’s proposals may be to raise equity by 0.5% and total capital by 0.5%. As Figure 1 shows, on the current implementation timetable these effects will step up from 2015 before accelerating strongly in 2019.

Immediate priorities in four areas
As banks look to prepare for these changes by building the right level of capital adequacy and optimising their ring-fences, they are likely to have four immediate priorities.

First, in terms of raising capital, while in the past the Treasury used the other group divisions to raise capital, it will now be more difficult to achieve. Furthermore, the current market conditions are hardly conducive to raising equity, meaning that more innovative forms of capital such as bail-in bonds will probably be needed. However, these are likely to be more expensive than standard debt. Asset sales may also be useful for raising capital.

Second, to retain earnings, the options include paying lower (or no) dividends, reducing operational costs, and generating higher revenues by boosting sales and/or prices. Cutting bonuses is also an option, and is the focus of increasing attention from politicians, regulators and activist investors.

Third, in order to cut down risk, banks may identify core assets and sell off others, reducing the size of the balance sheet. They may also decide to reduce the trading book and improve the balance of lending, while reinforcing their Pillar II models.

Fourth, and most radically, banks can change their business model by identifying the loss absorbency implications on both sides of the ring-fence. This involves looking at how the balance sheet is currently structured, and working out how to minimise capital requirements across the ring-fence, as well as its implications for funding and for the bank’s products and services.

Figure 1: The ICB’s projected capital impacts
Our view is that the location of the ring-fence will be driven as much by existing internal business considerations—such as balance sheet structure and the funding mix—as by market-facing factors. However, banks need to keep in mind the implications for their competitive positioning, culture and operations.

In practice, many banks may adopt a ‘tactical’ short-term ring-fence location aligned with their existing business structure until the regulations have fully evolved and the future market trends are clearer. Once any clear trends have emerged, banks may drop this interim approach and move their activities to long-term ‘strategic’ positions in relation to the ring-fence.

Given this likelihood, and the fact that the optimal ring-fencing structure will vary for every bank, there is no ‘one-size-fits-all’ solution. However, we believe there are four key factors that every bank should take into consideration in locating its ring-fence: capital constraints, funding, customer impact, and operational impact.

Key strategic challenges

1. Managing RWAs
   Banks need to work out the optimal approach for managing business with clients that attract a higher risk-weighting; how to withstand additional capital charges from elements such as the Credit Valuation Adjustment charge (CVA); and how to take advantage of capital reductions from Expected Positive Exposures (EPEs).

2. Optimising Capital
   Although the timetable for meeting the ICB capital requirements is likely to be in line with Basel III (i.e. extending to 2019), markets are looking favourably on those banks planning to meet the new requirements well in advance of that date. This means banks are incentivised to move early to consider their options for improving the quality and quantity of their capital, and for optimising collateral to reduce the impact of regulatory pressures on profitability.

3. Allocating Capital
   Internal allocation of capital needs to align with a principle of rewarding businesses on a ‘par’ basis, considering new measures for risk-adjusted return on equity (RRE). Alongside this is the challenge of managing one of the most controversial aspects of the financial crisis: appropriate compensation of staff. Regulatory limits on bonuses have encouraged higher base salaries, which have ultimately reduced flexibility in the cost base thus creating another challenge in addressing profitability pressures.

4. Changing the Business Model
   Finally, banks need to think through the restructuring needed in response to new capital and liquidity constraints, including the implications of the ring-fence, and where certain businesses sit and their impact on balance sheet management. The ring-fence proposals demand tough choices around how to manage and source support services whether shared or dedicated and therefore what operational efficiencies can be exploited.
Achieving and sustaining success in the new capital-constrained environment

In Accenture’s view, the keys to reducing the cost implications of the ICB’s proposals lie in understanding the cost of capital for serving clients and pricing correctly, managing RWAs to maximise risk adjusted returns, and ensuring that operations are underpinned by an efficient cost base. As Figure 3 shows, these objectives can be achieved through four steps:

1. Analyse the implications of the ring-fence to determine the new business model, products and services: Understanding the capital implications of the ring-fence allows the bank to determine its shape and location, and drive the types of products and services offered to clients and customers from ring-fenced and non-ring-fenced entities.

2. Understand cost-of-capital to develop a profitable pricing strategy: A bank’s pricing strategy is intrinsically dependent on a holistic understanding of the cost-of-capital for serving a client’s needs, to:
   - Manage counterparty risk performance
   - Increase product/asset return (Return on Asset/ROE)
   - Lower the cost of execution and deal servicing.

In combination, these steps help to ensure an efficient and effective client management workflow, delivering consistent global pricing for clients and truly reflecting the cost-of-capital in each transaction to support competitive yet profitable business.

3. Focus on efficiency: Manage RWAs to mitigate capital costs where possible, and drive operational resilience to reduce operating costs in two key ways:
    a) Operational excellence for RWA processes: An operational excellence for RWA management includes a number of processes that have direct and indirect impacts on the bank’s capital and counterparty risk, and drive operational resilience. The aims should be to:
       - Achieve operational excellence for processes that have a direct impact on regulatory capital release, such as collateral, hedging, netting, counterparty limits, client on-boarding
       - Improve effectiveness, in line with the bank’s risk mitigation and business strategy
       - Improve the accuracy of RWAs, as regulators will recognise and reward good operational management of risk mitigation processes and risk oversight, including CVA monitoring and risk concentrations.

   Operational excellence in these areas helps to create a fit-for-purpose risk management environment. This will enable the bank to reduce its RWA by containing any capital increase due to CVAs and from changes in the risk weighting for certain securitisations, while aligning the organization to its business strategy. Examples include readjusting its securitisation strategy and repositioning itself for the development and launch of new products.

   b) Operational realignment efficient processes: A bank’s operational costs can have a major negative impact on its profitability and capital reserve demands. So it should aim to:
      - Improve operational efficiency to reach cost/income ratios of around 40% for the retail business and 60% for the capital markets business
      - Improve data quality in the front-to-back processes for calculating market and credit risk, helping to achieve reduced RWA.

4. Identify growth opportunities: To identify and seize opportunities for growth, the bank needs to understand the core and non-core business in which it will be able to compete in the long term. Achieving the optimal mix of clients, products and markets is critical, and raises questions in four key areas:
   a) Identify geographical markets: What geographical markets are most advantageous to work in? Do regulatory factors mean the bank should restrict its business in some geographies more than others?
   b) Identify business markets: What business segments can the bank compete in most effectively? This is a particular challenge for the capital markets business. Not everyone can compete profitably in every segment and experience suggests one particular business segment can only accommodate four or five ‘flow monsters’.
   c) Identify Products: What products and services will differentiate between that bank and its competitors? If a bank’s trading in certain products is not profitable, it should consider exiting those product lines.
   d) Identify Customers: Which customers are most profitable? Customer segmentation is key for reducing the cost of serving unprofitable customers.
Building future differentiation

In the post-ICB world, the established drivers of high performance in banking – including outstanding management of risk and capital, efficient and effective capital allocation, smart and responsive pricing, and deep understanding of the strategic and operational impacts of regulation – will if anything be even more important than they are today.

With implementation scheduled for 2019, the ICB’s proposed regime may appear some way off. But the changes it envisions are so profound and pervasive that banks should start considering their impacts as a matter of urgency. Those that hit the ground running now will have a head start in the future race for differentiation in an even more constrained capital environment.