

The new Finance and Risk agenda

Capital management – New Challenges, New Opportunities

Introduction

Increased sophistication and liquidity in the capital markets, advances in analytics and changes to regulation and accounting standards are forcing banks to change the way they manage their capital. As a result, it is becoming increasingly complex for the Chief Financial Officer (CFO) and Chief Risk Officer (CRO) to balance the needs and expectations of internal and external stakeholders. With management decisions regarding capital (allocation and productivity, capital structure and capital raising, balance sheet and risk capacity, dividend policy, etc.) becoming ever more integral to strategy, corporate development and investor communication, banks require a more cohesive and dynamic capital management process.

Leading banks are responding to this challenge by setting up dedicated capital management functions that typically report to the CFO via an extended Asset Liability Committee (ALCO) or balance sheet management unit. The establishment of a dedicated unit reflects the growing number of stakeholders involved and the increasing number of capital measures (regulatory, economic, accounting, etc.) that must be managed. The focused nature of this unit supports a more dynamic and integrated approach to capital management, thereby allowing banks to address the increased volatility in capital ratios brought about by changes to regulation, particularly to Basel II and IFRS.

The dedicated capital management function must be equipped with the appropriate tools and processes to measure and manage capital. From a measurement perspective, this means building up the necessary tools to forecast and stress test future capital and earnings positions; from a process perspective, this involves integrating capital projections into the processes of strategic planning and financial communication.

Advanced capital management teams create value for their organizations by identifying opportunities to deploy surplus capital as excesses arise, by actively managing the level and deployment of the bank's capital and by ensuring that mechanisms are in place to manage down risk and raise capital should a future capital shortage appear. Critically, these gains can only be realized if changes to the capital management process are embedded throughout the organization via the strategic planning process. This discipline must be further reinforced at the Board level through increased involvement in capital management decisions.

This report discusses these issues and is structured as follows:

- New Challenges: Why has capital management become so important?
- Industry Responses: What pragmatic changes has the industry been focusing on?
- Getting Started: If we agree with this, how can we get the activation energy to get moving on this?

New challenges – Why has capital management become so important?

In the past decade, banks have become much more sophisticated in their capital and risk management capabilities. The losses suffered by the European and North American banking system in the early 1990s stemmed largely from a failure to link the risk-taking and strategy of banks to the risk capacity that they could realistically support.

Since then, the amount of excess capital in the global banking system has grown significantly. According to a recent Credit Suisse report¹, there was €100 BN of excess capital in the European banking sector in 2005 (equivalent to an excess of ~13%). The current excess capital environment creates a very different challenge to the capital-constrained environment of the early 1990s. Banks are therefore under increasing scrutiny with respect to their ‘capital story’ – “Should we return capital, seek organic growth or grow through acquisition?” Developing the dialogue needed to keep analysts, the investment community and regulators on-side requires a seamless link between strategy and finance.

In particular, three areas are key:

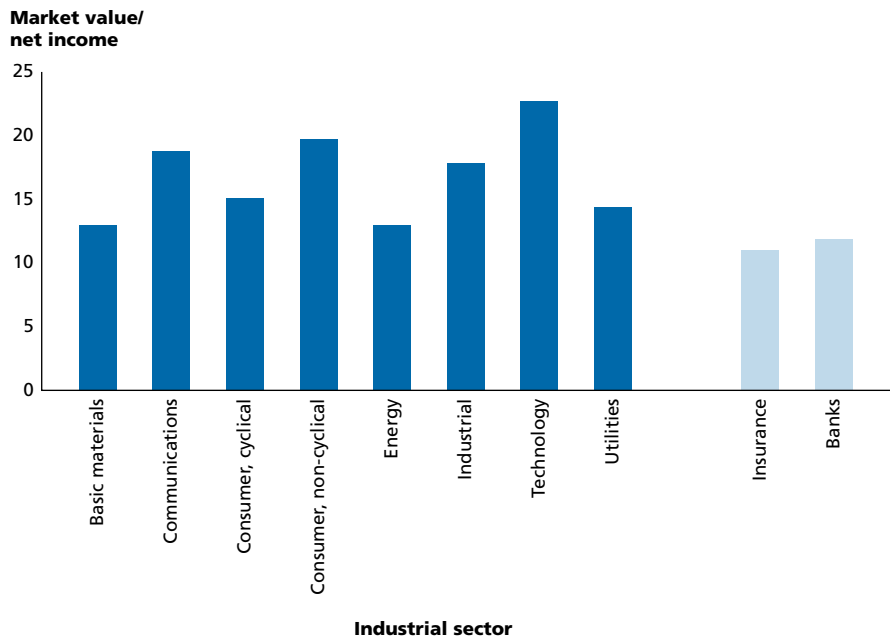
1. Effectively communicating the capital story to external stakeholders
2. Managing the rating agency and regulatory perspectives
3. Utilizing unused risk taking capacity

Communicating the story to external stakeholders

To date, financial services companies have a poor track record relative to other sectors in convincing the investor community of the quality and sustainability of their earnings growth. This has resulted in a significant price-earning (P/E) discount (as much as 30% in many geographies) compared to non-financial services companies, even though financial services profits have consistently outgrown gross domestic product (GDP) for the past 30 years. We will return to the topic of external communication in an upcoming article that will discuss the importance of taking a proactive approach to managing the market’s expectations.

¹ Credit Suisse, “European Banks Monitor”, February 2007

Exhibit 1: Comparison of PE multiple of industrial sectors



Source: Oliver Wyman analysis

Managing the rating agency and regulatory perspective – Is more better?

In recent years, rating agencies have placed increased emphasis on more quantifiable measures of current and future earnings, and on projections of capital coverage relative to risk exposure, as a more reliable input into the rating process. This shift has often been difficult for banks to respond to as financial reporting and capital assessment have largely been done on an ex-post basis, the link between strategy and future capital needs has typically been too opaque and ownership of the ‘capital story’ has been divided among Finance, Risk, ALCO and business lines.

Against the backdrop of perceived surplus risk capacity, banks risk being caught between their equity investors, debtholders and the agencies that rate their debt. This tension will heighten as the risk and capital needs of the banking balance sheet become more transparent to all stakeholders as a result of regulatory and accounting changes via Basel II and IFRS. There have already been ‘skirmishes’ over the degree to which Basel II will enable certain banks to reduce capital ratios. Much debate also has taken place as to the degree of ‘cyclicality’ that Basel II (and IFRS) will introduce into banks’ capital ratios and the resulting need for an additional capital ‘buffer’ to address this issue. So far, the messages from rating agencies have been mixed: S&P has stated that, in their opinion, there will not be any changes in ratings due to Basel II, and if banks actively remove capital from their balance

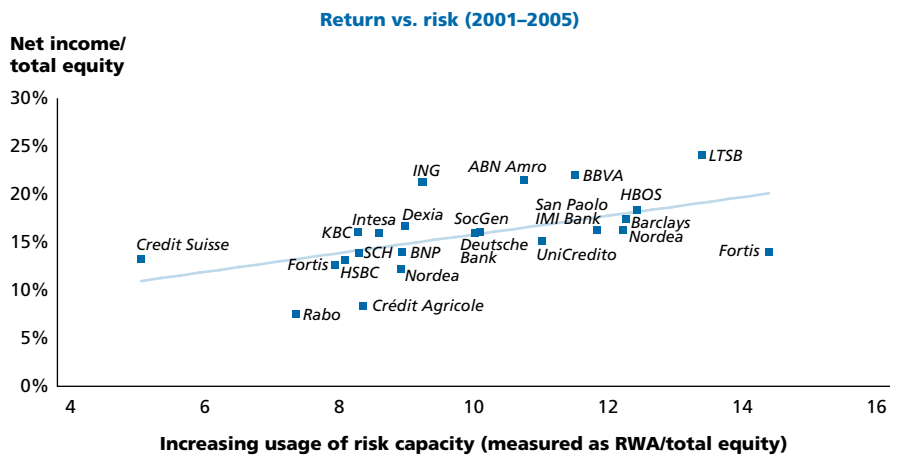
sheets, they will risk being downgraded². Moody's, conversely, has signaled that they will be open to some changes as they believe that capital is not directly correlated to ratings.

Utilizing unused risk-taking capacity

Put simply, banks that do not fully employ their capital will find it harder to meet the target return on that capital required by their shareholders (see Exhibit 2), as any buffer capital held will act as a drag on share price. While a buffer will always be necessary to manage balance sheet volatility and to fund potential acquisitions, the cost of its maintenance needs to be minimized through careful capital management. Key management levers include:

- Better communication with investors on the sources and future uses of available capital to finance growth
- Better management of the 'idle' capital in excess of that needed to support risks
- A business model that can increase the capital velocity of the balance sheet
- Better coordination of the management and deployment of capital across legal entities and jurisdictions

Exhibit 2: Analysis of the relationship between usage of risk capacity¹ and RoE for European financial institutions²



¹ Usage of risk capacity defined as "RWA/Total equity"

² Source: Bankscope data, Oliver Wyman analysis

Source: Oliver Wyman analysis, publicly available data

² "If a banking group were to reduce capital materially due to the anticipated change in regulatory calculation of risk assets, without any change in the bank's economic risk profile, it would be subject to a ratings review that could lead to a downgrade." – S&P, October 2004

Industry responses

Leading banks are responding to the challenges outlined above by moving beyond a regulatory-focused response to capital management and toward one that optimizes the competing requirements of shareholders, debtholders, rating agencies, and regulators by focusing on major areas:

- Governance and organization of capital management activities
- Integrating capital management into other strategic processes
- Advanced capital management tools and capabilities
- Proactive management of capital requirements

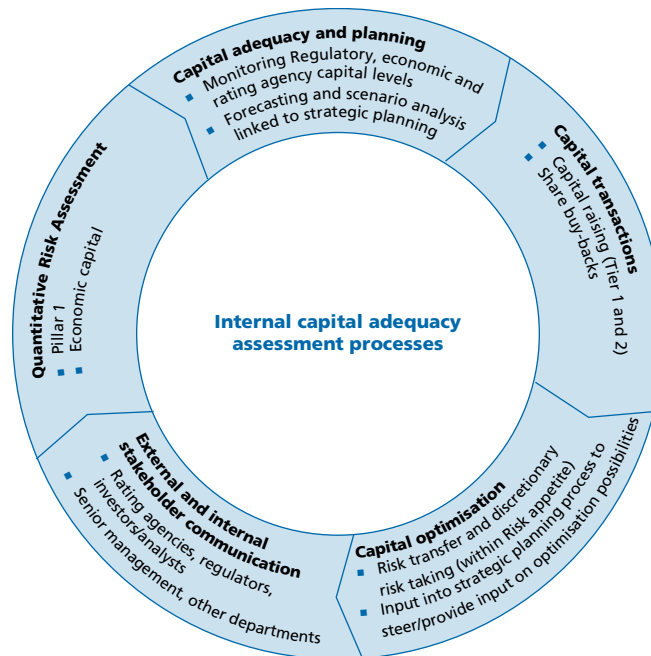
It is important to note that, although an ‘internal capital adequacy assessment process’ (ICAAP) required by Basel II includes these capabilities, the institutions that have realized tangible benefits are those that have focused on business needs rather than regulatory compliance. Indeed, we expect to see a wave of refinement/ redevelopment over the next few years from institutions that have taken the latter approach.

In the sections that follow, we will discuss each of these areas in greater detail.

Enhancing the governance and organization of key activities

To succeed, this requires an organizational solution that brings together a number of key activities into a coordinated framework. In defining the new organization, banks have approached this issue in two different ways, largely reflective of each one’s size and degree of centralization.

Exhibit 3: Illustration of key capital management activities



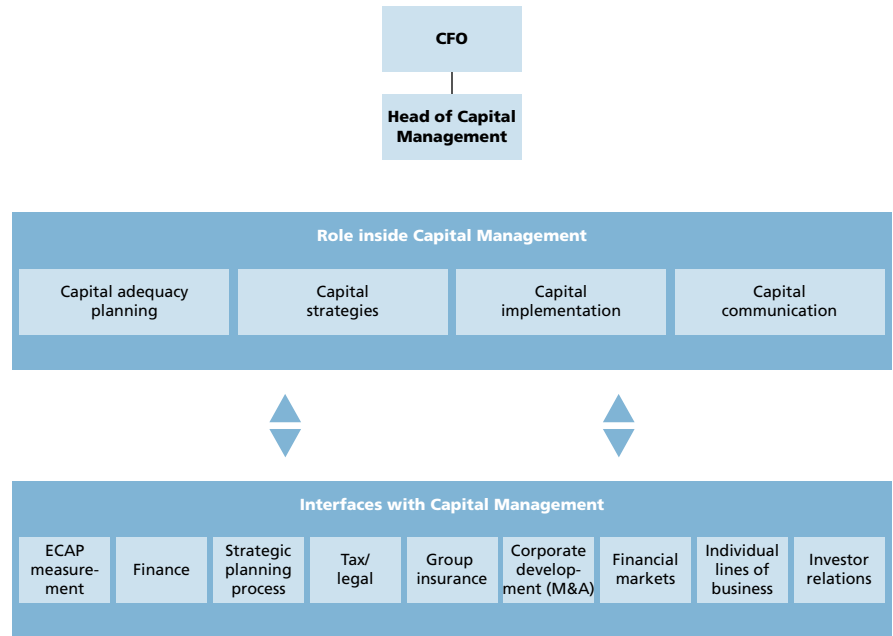
For regional institutions with relatively centralized functions, the typical approach has been to reinforce the network between the existing functions that have responsibility for the above activities. The advantage of this approach is that it minimizes structural change while increasing coordination and ensuring that different views are reconciled. This approach works best for smaller, more centralized players as the functions are usually already closely linked and key individuals have a regular, face-to-face working relationship.

Larger and more decentralized banks have established a dedicated capital management function that reports hierarchically to the CFO and functionally to either the Group ALCO or Group Board. Because capital management has such a wide range of implications, the key to success is balancing how much power this function should have in relation to the finance and risk functions and key business lines; too little mandate for coordinating these activities would be ineffective, while too much mandate could cause the capital management function to take on a life of its own.

The purpose of a dedicated function at the group centre is to establish, as one leading institution puts it, “one address for all capital-related issues in the group.” This function should then be able to ensure that, as the capital management process becomes increasingly complex, critical issues do not ‘fall between the cracks.’

The diagram below (Exhibit 4) shows the organizational model employed by a leading player in this area.

Exhibit 4: New structure for Capital Management



Integration with strategic processes

If the capital management group is to deliver value to the bank, its outputs must become embedded into strategic processes. The involvement of the capital management group in strategic processes can be both indirect and direct, as explained in more detail below.

Indirect involvement with strategic processes

The capital management group informs senior management on the current status of the bank's capital via a formal capital strategy. This strategy sets the terms of engagement for the allocation of capital in the planning round: the cost of capital, the amount of risk capacity available³ and the key capital constraints that face the group. This information can then be used to demonstrate to business units that they are competing for the use of bank capital and must themselves provide credible strategies to deliver the required returns on capital consumed.

³ See also our June 2006 article, "What's your risk appetite?"

The capital strategy can be delivered in the form of a detailed capital letter that covers:

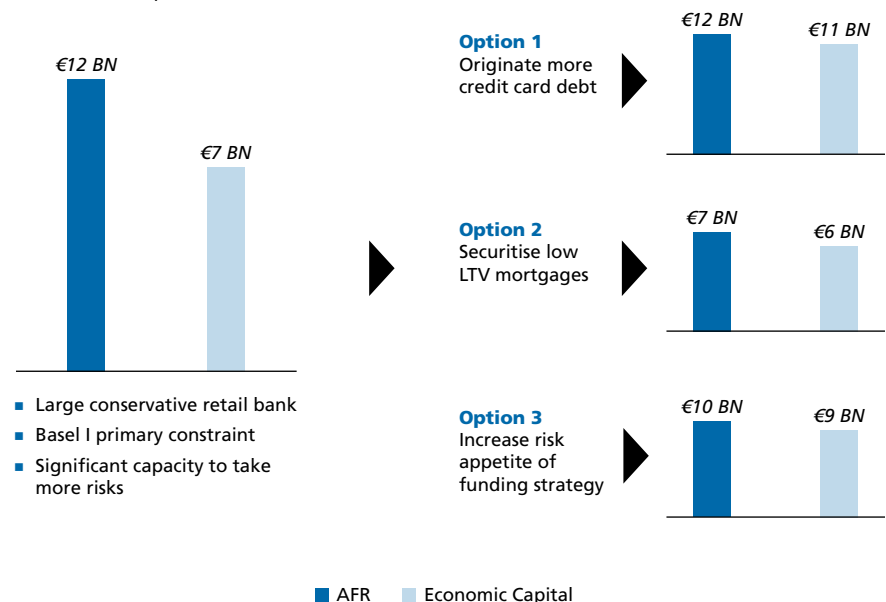
- Capital adequacy of the group and its subdivisions
- Capital forecast for the coming year (including analysis of a variety of scenarios)
- Assessment of the business and regulatory environment
- Assessment of appropriate targets for the business and its subdivisions
- Options for flexibility in financial resources
- Details on the cost of capital that should be employed

Direct involvement with strategic processes

In some instances, the capital management group can play a more direct role in managing the portfolio by providing guidance on strategies to enhance capital efficiency. For instance, the capital management group might guide a retail business with relatively low-risk/low-return assets to go down the credit curve via credit cards and subprime mortgages to improve earnings, while helping to close the earnings drag caused by idle capital. The capital management group can assist by mapping out the impact of the range of strategic options from a capital/available financial resources (AFR) perspective, as illustrated below.

Exhibit 5: Example of the strategic guidance offered by a capital management group for a conservative retail bank

Illustrative example



- Large conservative retail bank
- Basel I primary constraint
- Significant capacity to take more risks

Advanced capital management tools and capabilities

In order to support the increased involvement of the capital management group in strategic processes and to address regulatory requirements (i.e. Pillar II), the tools and capabilities for managing capital have advanced significantly in the last few years. These tools provide critical information for answering capital-related questions raised by senior management such as:

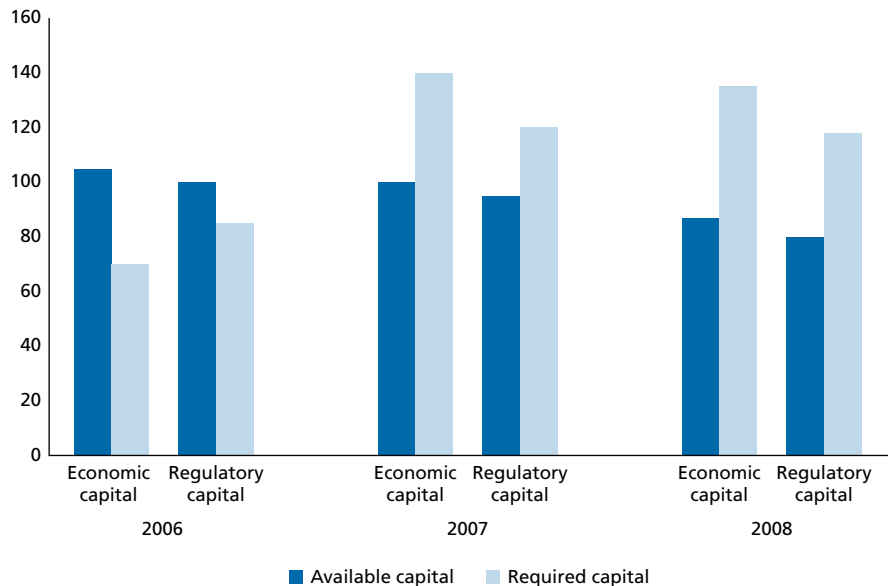
- How much capital should we hold, and how much buffer do we require?
- What is our contingency plan in case we are wrong?
- What should we do with our excess capital?
- What is the economically efficient rating, and what constraints do we face?
- How do we know that our capital is most efficiently deployed?

In our experience, too many of these decisions have historically been made by using either ad hoc analysis or pure 'gut feel.' Now leading banks make these decisions by combining extensive economic modeling with a governance process that balances the inputs of all the key internal stakeholders who are affected. Bank managers are right to be skeptical of over-reliance on complex modeling to project the capital needs of the bank. However, we strongly caution against taking capital decisions valued at hundreds of millions of Euros that are underpinned by ad hoc, incomplete and uncoordinated analysis.

A number of leading practitioners have developed tools that forecast the risk profile of the book (both the migration in credit quality of the stock of existing business and the credit quality of new flow). Based on this information these tools compare required capital, with a consistent projection of the bank's profit and loss (P&L) and balance sheet. A range of stress scenarios can also be analyzed and necessary contingency plans (such as capital raising, securitization etc.) can be designed to address solvency concerns in specific scenarios.

Exhibit 6: Example of capital projection under a 'severe recession' scenario for a European bank

Capital (required or available) €MM



The analysis shown above is similar to outputs generated by capital management tools used by a number of our clients. This analysis shows that in the event of a severe recession the bank in question will be under-capitalized from both an economic and regulatory perspective. To address this, banks can use this type of tool to design appropriate mitigation strategies - selling, hedging or securitizing assets to reduce risk-weighted assets (RWAs), increasing its divestment program, reducing discretionary risk taking/appetite, cutting its dividend, etc.).

Proactive management of capital requirements

As banks shift from a passive to an active approach to capital management, they are naturally seeking mechanisms that will help them to adjust and optimize the multiple capital constraints under which they must operate. Generally, two main mechanisms are employed:

1. 'Back-end' risk transfer transactions
2. Innovative use of hybrid capital to mitigate potential solvency issues without diluting shareholder returns

Back-end risk transfer transactions

Banks are increasingly looking to back-end mechanisms such as credit derivatives and securitization to manage their risk and capital positions. To date, the primary motivation of securitization transactions has been to arbitrage the BIS I capital regime in order to realign economic and regulatory capital requirements. These transactions have therefore typically targeted assets that have a high regulatory capital requirement relative to their risks, such as investment-grade corporate loans and residential mortgages. Credit derivatives, on the other hand, aim to remove concentrations in the larger, more liquid end of a bank's credit portfolio.

With the onset of Basel II, banks must rethink their transaction agenda to align with the new requirements. In particular, banks will need to achieve real risk transfer if they are to obtain any capital relief under the new regime. In addition, many of the low-risk assets targeted previously will now attract less capital when held on balance sheet. As a result, banks are both reviewing the types of assets they wish to target in these transactions and searching for new structures and mechanisms that will achieve real risk transfer. Additional requirements, such as the speed and cost of execution, also need to be taken into account. Exhibit 7 gives a high-level summary of the types of mechanisms used by advanced banks to actively manage their risks as well as the relative attributes of those mechanisms.

Exhibit 7: Typical attributes of mechanisms for managing risks

	Loan sale/ syndication	Co- investment	Index trades	Insurance	Securiti- sation	Basket trades	3rd party conduits	
WRA/BIS I relief	●	●	○	◐	◑	○	●	● Full BIS I relief ○ No BIS I relief
Risk transfer/ BIS II relief	●	●	◐	◐	◐	◐	●	● Full risk transfer ○ Zero risk transfer
Speed of execution	◐	◑	●	◐	◑	◐	◐	● Same day ○ >1 year
Depth of market	●	◐	◑	◐	◐	◐	◑	● Covers all segments ○ Covers no segment
Transaction cost	◐	◐	◑	◑	◑	◑	◑	● Significant 3rd party cost ○ Negligible 3rd party cost
Data/MIS requirements	●	◑	○	◑	●	◐	◐	● Requires bottom-up historical data ○ Requires no internal data
Transparency to clients	●	◑	○	○	◑	○	●	● Full BIS I relief ○ No BIS I relief

This type of analysis is becoming increasingly important, and we have helped a number of our clients optimize their market transaction opportunities. We will include further thinking on this topic in a forthcoming paper that will discuss leading capital relief and risk transfer mechanisms.

Innovative use of hybrid capital

The second area is the use of innovative instruments other than common equity to serve as capital. According to JPMorgan Securities, banks have been raising an average of US\$60 BN through innovative capital instruments globally per annum over the last few years⁴. Through their increasing acceptance and the lowering of capital requirements for some of these instruments under Basel II, we expect the use of these mechanisms to become more extensive and less costly.

The numerous examples of such instruments include perpetual debt (e.g. Rabobank's 'member certificates'), preference shares and other investment banking products (for example, JPMorgan's 'high equity credit securities'). The economic logic for using these instruments is persuasive as the risk premium associated with them is low; for example, 25 bps over a 10-year Dutch government bond for the Rabobank member certificates⁵ or less than 40 bps for some lower tier 2 capital (plus the tax shield). When this is compared to a risk premium of more than 350 bps for most common equity, the economic logic of these deals becomes clearly apparent; if it is not utilized, it could be a source of synergies for a potential acquirer.

⁴ Marc P. Jones, MD, JPMorgan Securities, quoted in The Economic Times November 2005

⁵ Rabobank Investor Relations: Rabobank funding & capital activities, 2006

Getting started

While the business case for advancing capital management capabilities is usually compelling, many institutions struggle to get started. The most common reasons that we have encountered are:

- Capital management must involve a wide group of stakeholders with divergent opinions on what needs to be done and how best to do it
- No single function within the bank has the full range of skills required to address all core issues of capital management; instead, they are spread out between finance, risk, the office of the chief executive and the capital markets/treasury area
- Creation of a more structured approach to capital management shifts power in the organization; in the short run, leaving things as they are is sometimes the easier solution

The best way to overcome these difficulties is to start with the most pressing issue. For many banks, this is driven by the timetable for implementing their Pillar 2/ICAAP framework. When adequately designed, this process sets in place an organizational framework that can later address new issues as they arise. For others, a significant excess or projected deficit in capital and resulting investor pressure may be the trigger. Once the near-term issues have been addressed, the broader issues of institutionalizing the approach can be tackled.

Regardless of the starting point, successful programs have shared the following common features:

- **Senior management buy-in.** Some banks have tried to approach these important changes in a bottom-up manner. This usually results in extended debates and discussions but no mandate to make crucial decisions. Instead, banks should involve senior management early on and thus ensure that the mandate to make the changes is in place to deliver the end vision. Senior management can then also ensure that roadblocks are quickly cleared and that pressing decisions are made

- **Sufficient investment, reflecting the likely returns.** A number of clients have started from a position of seeing capital management as a low value added 'bean-counting' exercise. As illustrated in this report, however, capital management can have a very large leverage effect on overall profitability. Thus, given the importance of the function and the relatively low number of required people (5-15 FTE), this is an area in which it is difficult to over-invest. Hence, get the best people and make sure they have a strong incentive to do well
- **Moving from measurement to management.** A number of banks have been stuck in a 'analysis paralysis' in which an enormous amount of time is spent analyzing every issue, thereby sapping the energy of change. Rather, where the solutions are broadly correct and actionable take action, make a management decision and move on to the next issue
- **Change takes time – let it.** If there are organizational changes required, then people will be nervous and not always willing to see the need for them. In the worst-case scenario, they will actively oppose changes. To overcome this, time must be set aside to address their concerns and explain the proposed change. Trying to take a shortcut will often result in a longer process in the end. To move things along, some of our clients have created an interim 'virtual' capital management team that is made up of parts of the disparate organizational groups. Once these groups have started working more closely together, a more formalized function can be established and the proper mandates assigned

Conclusion

Capital management has become an increasingly complex and challenging discipline - one that involves a greater number of stakeholders internally across finance, risk and treasury and externally across investors, rating agencies and regulators. The number and variety of capital and balance sheet management mechanisms have also exploded in recent years. Against this backdrop, it is clear that traditional capital and balance sheet management processes are poorly positioned to cope. Given the potential impact of effective capital management on an institution's bottom-line performance, we believe that there is a clear business case for upgrading current capabilities.

Looking forward, the efficient management of capital will only become more important; as Basel II goes live, there will be greater cyclicity of regulatory capital ratios, and external stakeholders will become increasingly informed and aware of the current and planned usage of any spare capital resources and/or potential capital shortfalls.

Although the ICAAP requirements of Basel II provide an incentive to enhance capital management capability, mere compliance with Pillar 2 will fail to produce any tangible benefits, and it risks becoming a distraction to more fundamental needs. Leading institutions are combining the capabilities discussed in this article with their risk appetite strategies and then layering these onto upgraded strategic planning processes. We believe that managing the complex interaction among risk, finance and strategy will be key in leading financial institutions to compete effectively in tomorrow's market place.

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