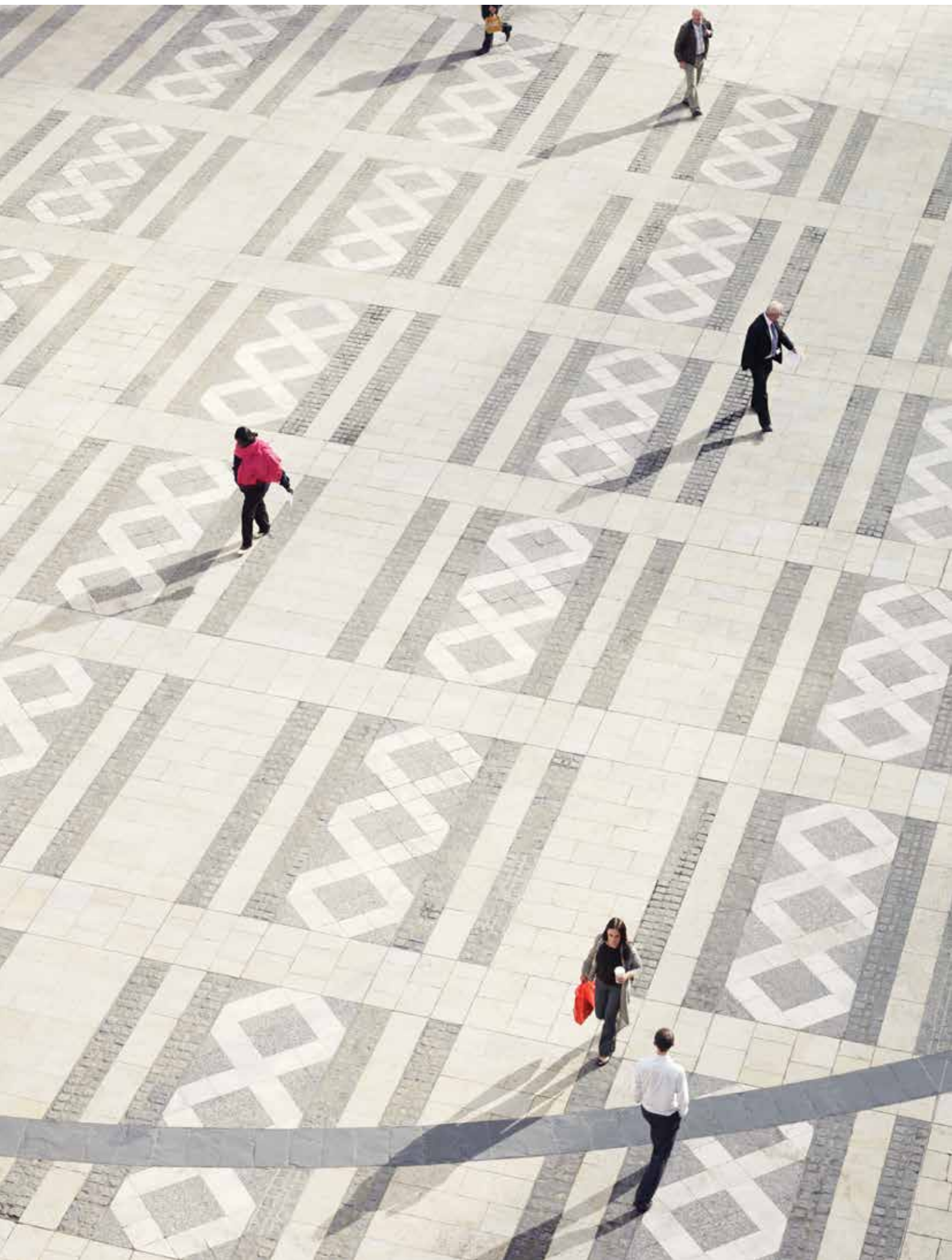

Banking industry reform

A new equilibrium



Part 1: Summary report





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Foreword

It is now five years since the onset of the credit crunch and almost four years since the collapse of Lehman Bros pricked the economic bubble and set in train what we now describe as the Global Financial Crisis (GFC), 2008 – 20xx. That's quite a long time for a full-blown crisis, on a global scale. And here in mid-2012, with banks still being downgraded and restructured, sovereign fiscal positions under severe strain, the European single currency under threat, and often contradictory proposals for restoring economic growth and financial stability being hotly debated, there is no sign yet of an end to it.

Understandably, the ongoing crisis is preoccupying the minds of policy-makers and business leaders the world over, and is arguably getting in the way of progress on more fundamental long-term issues – witness for example the lack of meaningful progress at the recent Rio+20 summit on sustainability and climate change.

But being understandable doesn't make it desirable. We will emerge from this crisis to a world outlook that is very different from what we remember going in, partly as a consequence of the crisis itself, and partly due to certain other global trends and developments that have been gathering pace alongside.

PwC has researched the long-term global business outlook extensively and published our analysis and views under the banner of 'Project Blue'. This forms the basis of our contribution to the debate at forums such as the World Economic Forum annual meeting in Davos as well as our discussions with boards and executives from our clients around the world. The central message from Project Blue is this: whatever companies may be doing in the short term, either in dealing with the crisis or just going about their business, they should recognise that the world around them is changing profoundly. For example, in addition to the ongoing growth in emerging markets, we anticipate a dramatic growth in trade and investment flows between them, such as between China and Africa, which, in physical terms at least, will bypass the West. This shift, together with trends in technology, demographics, socio-political conditions, and environmental and

natural resource pressures will dictate the evolving business environment for years to come. In the context of financial services, Project Blue also sets out some key respects in which the world has clearly already changed: new regulation; a new landscape of societal expectations with much more active public scrutiny; a stalling of growth in Western economies; and a spike in sovereign and currency risk, to name a few. A summary of our analysis and views from Project Blue is available on our website at www.pwc.com/projectblue.

Meanwhile, since the banking industry has been at the heart of the financial crisis from the start, bank boards and executives are every bit as preoccupied with the immediate stresses and strains of the crisis as their peers in the political and wider commercial spheres are. We are witnessing this at close quarters: through our direct support to our banking clients as they refinance, restructure and reposition their businesses and respond to regulatory reforms; and through our work with various government agencies as they develop and execute measures to stabilise their banking sectors and reposition them to play their part in restoring economic health.

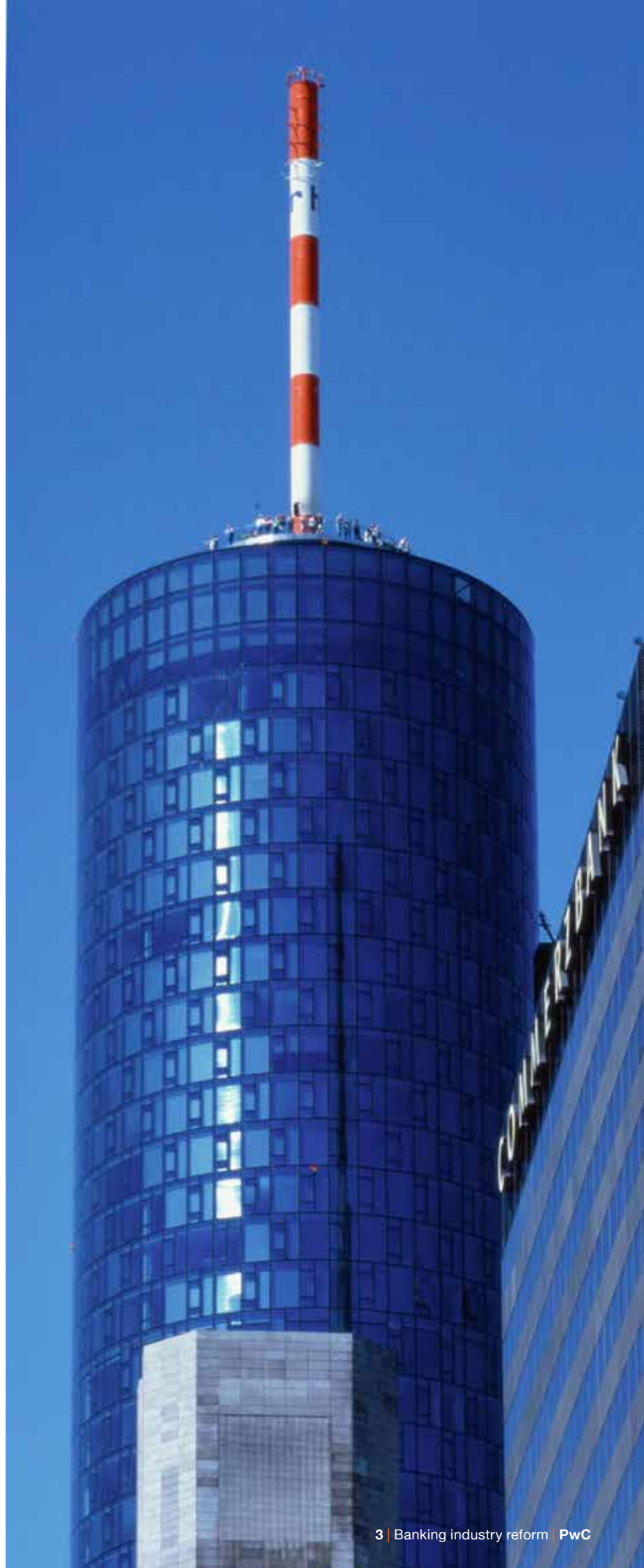
But our message from Project Blue still stands. While of course banks must prioritise responding to the crisis and the industry reform agenda, the manner of their response needs to take account of the way their world is changing. Otherwise, banks run the risk of emerging from the crisis recapitalised, restructured, reformed...but irrelevant. Indeed, there are some respects in which we believe their responses may even be counterproductive in the short to medium term, chiefly in their responses to actual and perceived pressure from regulators and investors.

The purpose of this paper is to examine these questions in some detail. Whereas Project Blue paints a picture of the future and challenges banks and others to come to terms with that future, this paper looks at things from the perspective of the challenges banks are facing today in working through the crisis. It explores how they should frame their responses – dealing with the crisis in the short term while emerging from it in good shape for the longer term. While we do sound some alarms, in looking ahead we also strike a note of optimism in that, as the world needs a stable and vibrant banking system, one way or another it will discover a way to have one. Ultimately, we believe that this is both a natural and inevitable outturn, and also a source of opportunity for those with the foresight, resources and leadership to make it happen.

While the body of this paper delves into some technical detail, the overall messages are meant for a board and senior executive audience. These messages are captured in this Summary Report (Part 1), while Part 2 provides the supporting arguments and analysis as well as an overall conclusion.



For more in-depth discussions on the topics raised in this paper, please refer to our more detailed analysis in 'The New Equilibrium - Part 2: Detailed report' online at www.pwc.com/banking



Summary report

Headlines

Why read?

In this report we look at the issue of banking industry reform and its implications for bank strategy. Specifically, we argue that bank responses to the reform agenda need to be reframed by the realities and opportunities of a new world.

We also argue that these realities have seemingly not yet manifest themselves clearly; that the trend of responses is seemingly conditioned by certain beliefs and expectations that are outmoded; that certain aspects of bank regulation are introducing further distortions and distractions; and that to break out of this, and open the way to new

opportunities and a prosperous future, banks need to renew their ‘licences’ with the investors, communities and customers they serve. They also need to swim with the tide – work with regulators, restore confidence and embrace fresh equity where they can. The highly levered bank model is a thing of the past.

We see a substantial prize for banks that are successful in doing this as, contrary to some claims, we do not regard industry reform as having critically undermined the economics of banking, nor rendered unviable any part of it for

which there is a legitimate societal need.

On this basis we predict average industry equity returns will settle in the 9–11% range. Although this is below current industry targets, and well below pre-crisis levels, on a degeared equity cost base of 8–10% economic profit margins of 1–2% should be achievable (compared to between -3% and -5% on 2011 figures), per the table below. Following historical precedents, this should enable a re-rating of bank stocks of around 20% initially once investor confidence returns, and of 100% plus once a new equilibrium is established. Investor confidence is the key.

		Pre-boom (2003)	Pre-crash (2007)	Crisis fall-out (2011)	New equilibrium
Leverage		23x	31x	19x	<20x
Cost of equity (CoE)	Market assumption	9%	10%	12%	-
	Leverage adjusted	-	-	10%	8 – 10%
Return on Equity (RoE)		12%	20%	7%	9 – 11%
Economic spread (RoE – CoE)	Market assumption	3%	10%	-5%	-
	Leverage adjusted	-	-	-3%	1 – 2%

Source: PwC

Key messages

A permanent shift to a ‘new equilibrium’

The financial crisis has changed everything. Policy makers and regulators are leading the reform agenda and forcing the pace, but they are only the catalysts. The real drivers – the expectations of a wider set of stakeholders, and the realities of a new economic and commercial landscape – will fundamentally and permanently reshape the banking industry. A new equilibrium will emerge in terms of performance benchmarks, industry structures, business models, financial structures, taxation, products, pricing, conduct and remuneration. We paint a picture of this.

Part 1 Summary report: pages 6; 13-20

Part 2 Detailed report: pages 7; 29-42

Bank responses could be counterproductive to themselves and to the economy; more intervention is in prospect

Current bank responses are a mixed bag of sound, disciplined business adjustments, messy reactions to short-term regulatory and other imperatives, and potentially damaging overreactions and distorted reactions to events. Efforts to restore return on equity (RoE) and optimise regulatory capital usage are dominating the change agenda. Both have their place, but can lead to false economies, value destruction and market disruption. Both could frustrate the objectives of industry reform and lead to further regulatory and public policy interventions. This prospect is further undermining investor confidence.

Part 1 Summary report: pages 7-8

Part 2 Detailed report: pages 7-11

The world needs a stable and vibrant banking industry, and will find a way to have one.

Banks and bank investors need to reset expectations

A return to RoE in the mid-teens is unrealistic and unjustified. We estimate that the cost of equity (CoE) will subside to 8–10% as bank balance sheets are strengthened and the systemic riskiness of bank assets (which spiked in the crisis) returns towards historical norms. Maintaining hurdle rates in the mid-teens will result in value being left on the table. While the drag of further asset deflation/impairment, weak economic growth and capacity overhang will depress RoE in the short term, thereafter, industry average RoE will recover to a ‘healthy’ equilibrium of 9–11%. There are strong historical precedents for RoEs at this level to coincide with valuation multiples of 1–1.5 times.

There will be substantial variation around these averages, reflecting increasing disparity in business models, risk profiles and capital structures. RoE was never a good comparative or absolute performance indicator and it is positively misleading now – we advocate that banks and investors should focus on economic spread (ES: RoE minus CoE) performance instead.

Part 1 Summary report: pages 9-10; 13-14

Part 2: Detailed report Pages 13-19; 29-32; Appendix

Banks need to reinstate ‘economic’ decision tools, not get drawn further into regulatory models

Although regulatory formulations dictate aggregate capital requirements, they should not feature unduly in business decisions at the margin, in areas such as business mix and deal pricing. Where they give rise to a genuine constraint, and a need to optimise within that constraint, the basis of optimisation should be economic, and not be corrupted by regulatory bias. In any event, optimisation should be influenced strongly by longer term strategic considerations such as the integrity of the franchise, competitive positioning, and future growth options as and when the constraints ease.

Part 1 Summary report: pages 11-12; 16

Part 2: Detailed report Pages 20-28

Fresh equity is sorely needed, but the confidence crisis needs to be overcome

As a means to restructure, deleverage on the asset side only goes so far; it leaves value on the table and it is highly procyclical. The sooner that banks can delever by raising fresh equity, the better for them, their investors and the wider economy. Dilution of equity returns is not the real barrier to this. The real issue is the deep-rooted crisis of investor confidence in the sector, fuelled by anxiety about more bad news in the pipeline; economic, market and regulatory uncertainty; and perceptions of systemic control weakness and poor conduct. Confronting this should be the highest priority.

Part 1 Summary report: pages 10; 18

Part 2: Detailed report Pages 19; 29-32; 41-42

There is a bright future

Beyond the crisis, there will be opportunities in new economies, markets, demographics and technologies. Banks have a major role to play in helping to tackle some of the world’s toughest economic and environmental challenges. With effort and permission, they can and will transform their status and image from being the core of the problem to being a key part of the solution.

Part 1 Summary report: pages 15-16; 20

Part 2: Detailed report Pages 36-40; 43-44



Policymakers and regulators are intent on reforming the industry and won't stop until they are satisfied that the job is done.

Introduction

The financial crisis has triggered a seismic shift in the banking industry. There have been crises and reforms before, but the depth of this crisis and the determined nature of the regulatory response mean that this time really is different. The banking industry is not going through a simple cycle or period of consolidation or adjustment. We think that in the next three to five years the industry will settle into a new equilibrium that will be very different from the past. In other words this shift will be a permanent one.

This paper examines how we think banks should frame their responses to the changing landscape. Among other things, we argue that banks are overly focused on risk-weighted asset (RWA)

calculations, and too sensitive to return on equity (RoE) dilution, which is an inevitable consequence of the recapitalisation that lies at the heart of the reforms. Specifically, we believe that pursuing too ambitious an RoE target will result in false economies, and that following an RWA optimisation mantra too rigidly will result in distortions of business decisions in crucial areas such as strategy, investment, business mix and product pricing.

More damaging still, these reactions could interrupt the provision of credit and other financial services in the marketplace, disrupt customer relationships, pose procyclical threats to the wider economy and thereby induce a vicious spiral in their own fortunes.

Moreover, as this is clearly not what policymakers intended, banks should be conscious of the possibility that their actions, though they may be rational at one level, risk frustrating the intentions of policymakers and thereby risk precipitating a fresh wave of intervention and regulation (Basel IV).

The general thrust of bank responses is conditioned by beliefs and instincts that belong more in the

Conditioned responses

The thrust of banking industry reform is to try to ensure that banks are better capitalised, more liquid, more securely funded and generally better ‘behaved’ than before. This is generally believed to have profound implications for the economics of the industry. While banks are clearly getting the message that policymakers and regulators are serious, and are working feverishly to adjust their business models, we find that the general thrust of their responses, reinforced by press and analyst commentary, is conditioned by certain beliefs and instincts that belong more in the old world than the new.

Specifically that:

- The new capital requirements being foisted on them have added a substantial further cost burden that they will need to cover; because
- Investor expectations, themselves conditioned by many years of inflated double-digit RoE performance, are essentially fixed and will need to be satisfied in order for banks to attract and retain the levels of equity that regulators are demanding.

These beliefs, coupled with the targeting by regulators of certain product areas for particularly onerous treatment (especially in terms of regulatory capital and liquidity requirements), have triggered a flurry of responses ranging across the introduction of large-scale asset disposal programmes, aggressive cost reduction measures, business and product rationalisations including curbs on new business growth, pricing adjustments, and changes to an array of commercial and operational practices particularly in the areas of collateralisation and settlement. To some extent they also obscure a crucial aspect of the post-crisis world, which is a fundamental shift in the funding landscape and the costs associated with that.

All of this is being done ostensibly with the aim of restoring RoE to as near pre-crisis levels as possible, and following a new mantra of ‘RWA optimisation’. As an indication of the scale of this, a recent report by Morgan Stanley and Oliver Wyman as reported by the Financial Times (25 March 2011) foresees that over the next one to two years wholesale banks globally will cut a further US\$ 1 trillion (up to 15%) off their balance sheets and take out US\$10–12bn in costs through pay cuts and retrenchment, in an effort to restore RoE to a 12–14% range.



There is no prospect of the industry delivering anywhere near pre-crisis levels of nominal RoE performance. It is a mistake

The good, the bad and the ugly

While efforts to restore RoE and optimise regulatory capital are laudable on the face of it, a closer examination of these actions reveals a mixed bag of sound, disciplined responses; costly diversions; and more seriously damaging overreactions and distorted reactions to what's going on.

The main issue is that the performance expectations and decision rules that formed in the pre-crisis era are no longer valid in the new world, due largely to the substantial restructuring (degearing) of bank balance sheets. By some estimates, as much as 4 percentage points of pre-crisis RoE was attributable to gearing alone. With gearing largely off the table, underlying economic growth substantially subdued, and an overhang of excess capacity pressurising margins, there is no prospect of the industry delivering anywhere near previous levels of nominal RoE performance. We believe it is a mistake for banks to try.

By the same token, the application of decision rules (e.g. on investment hurdle rates and product pricing) that were formed pre-crisis, without adaptation to the economic realities of the post-crisis world, is bound to create distortions.

But as we say, the responses are a mixed bag comprising the following:

- **The Good.** In many institutions the banking boom years masked the onset of a number of problems such as poor cost control, ill-disciplined investment, poor culture and weak risk and financial control. The strictures arising directly and indirectly from industry reform are now prompting banks to refocus

on their core businesses and to introduce the sort of cost, investment, behavioural, risk and financial disciplines that should have been in place all along. This is obviously a healthy development.

- **The Bad.** However, the reform agenda is also driving substantial adjustment and opportunity costs, both for banks themselves and the markets they serve. The sheer scale, complexity, interrelatedness and urgency of regulatory change mean that it is nearly impossible to respond to it in a considered and efficient way. As well as the fragmentation, overlap, overspend, delay and even error that can stem from this, the fact that the regulatory goalposts are either blurred or keep shifting adds a degree of paralysis to the mix. Bank customers are feeling it too through disruption to the continuity, quality and cost of banking services. Meanwhile, attention and resources are being diverted away from a host of initiatives that are crucial to banks' long-term rehabilitation: researching and responding to customer needs; investing in new talent, new technology, new products and services; and adjusting their business models and strategies to the demands, pressures and opportunities of a new age. There are obvious messages for banks, policymakers and regulators in this.
- **The Ugly.** At the more extreme end of the spectrum, we see banks' responses to industry reform potentially causing significant and lasting damage to their businesses, the industry and the wider economy. For example, overshooting on the 'good' responses in a way that undermines future productivity, quality and growth; allowing the 'bad' responses to result in an entrenched culture of fire-fighting, management by regulatory proxy, herd behaviour and general short-sightedness; overcorrecting on price in response to false cost signals; distorting business portfolios; disrupting customer relationships; giving up options by exiting superficially underperforming (but fundamentally sound) business

lines; and exacerbating asset price deflation and economic procyclicality by selling 'non-core' assets in fire sale conditions to hit ratios early. Perversely, there is also the worry that banks will become reckless in taking new risks or engaging in aggressive or even unethical market practices to try to meet unrealistic RoE targets.

Of course, industry reform isn't just about capital and funding. From Dodd-Frank in the US to MiFID in Europe, the reform agenda is also forcing through prescriptions on what banks may do and how they may do it, as well as how they finance what they do. But as with the capital rules, if the underlying performance targets are unrealistic, and if the incentives to meet them are strong enough, there is bound to be an element of distortion, or worse, in how they are responded to.



It doesn't have to be this way

Despite the forgoing, we actually have quite an optimistic outlook, so long as banks can adapt themselves to what we call the 'new economics' of banking and can bring their stakeholders with them.

The key adaptations required are:

- A recalibration of RoE targets to take account of the new leverage structures being introduced.
- With regard to 'taking their stakeholders with them', a concerted response to the general crisis of confidence in banks and banking that is the true barrier to the flow of equity and funding, and the true source of wider stakeholder friction.
- A resumed focus on economic performance indicators such as economic profit (EP), economic spread (ES – the margin of RoE over CoE), and a refinement – on economic principles – of product pricing, internal transfer pricing, and portfolio optimisation methods.
- A more strategic approach to portfolio optimisation and business investment that takes full account of longer term economic, market and commercial scenarios, and recognises the value of options.

RoE goalposts have changed and become blurred

RoE is fine as an indicator of bank performance, period-to-period and from one bank to another, when capital structures are relatively stable and are relatively common across banks. Otherwise not, because changes and differences in capital structure have a fundamental bearing on both the return on equity (due to the dilution/concentration of returns to equity holders) and also the cost of equity (CoE) (likewise, due to the dilution/concentration of risk to equity holders). This relationship, courtesy of the seminal work by Modigliani and Miller (MM) in 1958, and much research and debate since, also features in the industry standard model for estimating the CoE – the capital asset pricing model (CAPM) – so it should be well recognised, even if it is not wholly bought into. On this basis, while still not perfect, and certainly not new, we posit that economic spread is a far superior comparative performance indicator to RoE.

The debate over MM, and whether it applies to banks, has gone on in the background for years. And it is still going on with, to put it crudely, policymakers arguing that banks and investors should be happy to have additional capital (as MM implies), and banks resisting this conclusion on a variety of grounds.

Two popular objections to MM are, first, that it is an overly theoretical construct that doesn't take various 'real-world' conditions (such as tax, imperfect markets and investor risk appetite) adequately into account and, second, that there is no evidence yet of a drop in the CoE, following the degearing that has so far taken place, as MM and the CAPM predict.

Economic spread is far superior to RoE as a comparative performance

CoE will come down to below pre-crisis levels. RoE targets should correspondingly fall.



Although people might debate the finer points of MM, we believe that bank capital requirements and funding structures are now being forced to change to *such* a degree, and with *such* disparity in extent and timing across jurisdictions and products, that some recalibration of expectations and decision rules is surely needed if the distortions we refer to are to be avoided. We believe this should be broadly along MM lines.

We show, through a worked example of the MM proposition, that there are very plausible ‘real-world’ conditions in which a bank’s economic profit (EP – the excess profit after all economic costs including capital costs have been met) would be unaffected, or even enhanced, by an equity injection. Whether a bank’s EP goes up or down with a capital injection depends mostly on the marginal rate of tax (where higher marginal tax rates favour debt financing), and the risk premium paid on its wholesale funding (where higher premia favour equity financing). We suggest that while these two parameters have been finely balanced in the past, at present, they are set and trending further towards favouring equity.

With regard to the empirical evidence, we argue that the standard application of the CAPM picks up gearing effects only with a substantial lag. Whereas, based on an isolation of gearing versus other CoE drivers, we argue that there are two substantially offsetting phenomena at present: an increase in underlying bank asset risk, plus the quasi-gearing effect of policy measures to unravel the implicit government guarantee, pushing the CoE up; and reduced financial gearing bringing it down. This implies that if it wasn’t for the moderating effects of reduced

gearing, the cost of equity would be higher still! We suggest that the latter is permanent while the former (with the probable exception of the lost guarantee) is transitory. We therefore suggest that the CoE will come down in due course, to below pre-crisis levels, as MM and the CAPM predict. RoE expectations and targets should correspondingly fall.

Investor expectations will shift eventually

Where does this leave investors? Bearing in mind that their expectations have also been conditioned by the pre-crisis boom years, they may simply want a decent (i.e. minimum mid-teens) return on their equity and will withhold their money until promised sector returns come back to these levels. Against this, we argue that investors are not being asked to accept worse performance as such – they’re just being asked to accept a different risk/return proposition from the one they’re used to. We suggest that equity investors are not a homogenous group and that, in the long run, as many will be attracted by the new risk/return proposition as will be repelled by it. Meanwhile, since it is only dilution we’re talking about here, if any are still unhappy with the risk/return profile offered by banking stocks, they can always offset this by introducing gearing into their own portfolios, or tweaking their asset allocations (more equity, less fixed income), to suit their particular investment goals. Or to save investors the trouble, we might even see banks creating geared versions of their own stock through special purpose vehicles (SPVs), or fund managers doing something similar on baskets of bank stocks.

Meanwhile value is being left on the table

But the biggest reason why we believe investors’ RoE demands will shift is because of the current presumption that they won’t; the related misconception that big blocks of bank business have been rendered uneconomic by industry reform; and the industrywide response of pulling out of (the same) supposedly marginal businesses, selling off ‘non-core’ assets to increasingly unwilling buyers and curbing new business growth, are all resulting in value being left on the table for lack of capital. That situation can’t last for long.

While we accept that there are big obstacles to raising fresh private-sector equity to resume investment and growth in the current climate, we think this has very little to do with gearing and dilution. Rather, it is the result of a more fundamental crisis in investor confidence in banks fuelled by the still steady flow of embarrassing errors and misdemeanours; anxiety that there is still a lot more bad news in the pipeline; anxiety about the possibility and impact of further government and regulatory intervention; and constant reinforcement through the media that banks lie at the heart of the wider economic turmoil, especially in Europe. Turning this around will take a great deal of effort, so alongside presenting the positive side of the shareholder value proposition, we see tackling the confidence crisis as an absolute priority if the industry is to take itself out of reverse gear and restore access to equity markets.



Banks that are relatively better capitalised should have a structural pricing advantage. This is the opposite of the conventional view.

Banks need to reinstate 'economic' decision tools, not get drawn further into regulatory models

As hard as it is to interpret and recalibrate to the new economic realities, there is also the risk of over-interpreting regulatory formulations and allowing them to displace economic considerations in areas such as pricing and portfolio management.

In the case of pricing, individual banks are interpreting the extent and cost of industry reform in different ways, and also being inconsistent in how and when they respond on pricing. This is making it extremely hard to get a reliable read on the market. Anecdotally, some banks are taking a lead in reformulating their pricing models to take account of what they see as the new market and regulatory realities, but in doing so are getting undercut in the marketplace. Those not taking a lead, whom the leaders would view as victims of adverse selection who will pay a price in the end, are either being slow to respond, or else have a positive hunch that the leaders

are overreacting or reacting to false signals. This group is glad of the chance to pick up some market share ('beneficial selection' to coin a phrase). Who's right? Is there a chance that some are doing the right thing (i.e. being prudent) but getting it wrong, while others are doing the wrong thing but getting it right?

To generalise, 'getting it wrong' in this context means allowing regulatory formulations of, for example, capital usage to drive pricing in a way that departs from economic fundamentals. We see a strong tendency for banks to price in capital costs, based on Basel III RWA calculations, regardless of what an economic risk charge would be, irrespective of whether they are capital-constrained, or if they are, without necessarily thinking through the marginal cost or wider commercial implications of that. Whereas, our analysis suggests that the key to 'doing the right thing and getting it right' is to differentiate very clearly between (i) systemic, economic costs (likely to be common across all institutions, and to underpin a 'market-consistent' level of pricing); (ii) idiosyncratic, economic costs (particular to the institution, including with respect to regulatory capital constraints); and (iii) non-economic costs (typically arising from artificial internal cost allocation frameworks which, intentionally or otherwise, do not represent true economic costs at all).

One implication of our analysis is that the existence of capital constraints gives rise to a frictional cost under category (ii) and, as such, banks that are

relatively better capitalised (i.e. are less capital constrained) should have a structural pricing advantage over those that are less well capitalised. This is the very opposite of the conventional view.

RWA optimisation is a more conspicuous and potentially more destructive example of regulation displacing economics. At its most extreme, this can take the form of the 'RWA intensity' of business categories being given a first-order prominence in setting overall bank strategy. Nevertheless, while our starting point is that banks should endeavour first and foremost to alleviate portfolio constraints (i.e. fix the problem on the supply side), for many banks it is true that the Basel III capital rules will kick in before they have had the chance to build up their capital stocks. So they have no option but to find ways to reduce their regulatory capital needs.

Most organisations in this situation have identified and got to work on the 'low-hanging fruit' such as cleaning up data and models, restructuring capital to ensure favourable tiering treatment, and disposing of genuinely non-core assets. Where it gets trickier is when the low hanging fruit doesn't get them far enough, fast enough and they need to make tougher decisions, for example to cut back business lines that, while attractive from a long-term strategic perspective, are hard to justify in the context of short-term capital constraints.

The key question is how these optimisation decisions should be taken. The blunt approach is to rank businesses according to their contribution, relative to RWA usage, and then to weed out the weakest until the constraint is satisfied. To be fair, it is never as mechanistic as this and decisions of this nature are debated long and hard. But there are two potential sources of bias to highlight:

- One is the tendency to allow RWA usage to corrupt the ranking analysis by letting it drive the numerator (contribution) as well as the denominator (RWA usage). This can happen when the existing performance measurement regime involves internal capital charges that are themselves RWA-driven – a common practice. Another common approach, for those intent on maximising RoE rather than EP, is to rank according to top-line returns relative to RWA usage (return on RWA, or RoRWA). Neither of these approaches will optimise economic performance, whereas our analysis shows that ranking based on an economic, risk-adjusted measure of contribution such as EP, relative to RWA usage, can yield a startlingly different portfolio composition and a superior aggregate EP result.
- The second potential bias is to allow short-term portfolio optimisation (subject say to an RWA constraint), even on the economic basis we advocate above, to dictate and distort longer term strategic and commercial outcomes. Whereas a more strategic approach should:
 - look first to relieve that constraint – or at least anticipate future periods in which that might be possible – before performing irreversible surgery
 - consider the long-term integrity of the business in terms of its brand and customer offering, recognising that individual businesses do not perform in isolation from each other – either commercially or operationally –

rather than letting it get bent out of shape by (in this sense) arbitrary regulation or short-term market frictions

- anticipate how the actions of competitors (who of course are subject to the same pressures, constraints and regulatory prescriptions) might change the commercial landscape – for example if a large part of the industry is forced or induced into less RWA-intensive product areas, it will compress margins there while creating opportunities in more RWA-intensive product areas for those with the capital resources to exploit them
- allow other strategic imperatives, such as adapting to new global economic and environmental conditions and the evolving expectations of other stakeholders (not just regulators), to also drive short-term actions, and
- build in as much flexibility as possible to respond to changing conditions, recognising the value of strategic options in a volatile world.

More fundamentally, there is something perverse about the thought process, implied in Portfolio Optimisation, which starts with the question: ‘We have X Capital... what’s the best thing to do with it?’, when a more strategically coherent question would be: ‘We see a profitable opportunity to service the needs of *abc* customers, with *xyz* products and services, in *αβγ* ways ... what resources do we need for that?’

In many respects, it is this focus on customers – who they are, what they need, what they will happily pay for, and what packaging, delivery and service attributes they will value – that has been missing. This is certainly a strong theme in many aspects of industry reform and general critical commentary on the crisis, namely, the accusation that, pre-crisis, banks went on a binge of product elaboration, ornamentation and aggressive marketing that went beyond underlying legitimate customer needs.

If a large part of the industry is forced or induced into less RWA-intensive product areas, it will compress margins there while creating opportunities in more RWA-intensive product areas for those with the capital resources to exploit



The future equilibrium

While the main purpose of our report is to examine how banks should interpret and respond to industry reform, we also look ahead and project where we think things will ultimately settle out – a future equilibrium. Specifically, we present our views on the implications of reform for:

- leverage, equity costs and equity returns
- tax
- industry structure and business models
- product offerings and pricing, and
- conduct and reputation.

Leverage, equity costs and equity returns

We believe that over a 3–5 year period the banking industry will settle into a new long-run equilibrium financial model, defined in terms of a capital structure that satisfies all stakeholders;

where the relative costs of debt and equity have readjusted to reflect their respective share of the risk burden; where the various legacy debt and equity cost premia from the financial crisis have ebbed away as much as they are going to; and where price competition has driven average equity returns down to a reasonable and sustainable margin over that cost.

Putting numbers to this, we expect that with leverage ratios settling out at less than 20 times, the industry average CoE will fall to around 8–10% through the combined impact of reduced gearing and the more gradual subsidence of the other factors that are holding CoE up in the short term (equity market risk premium (EMRP), bank asset betas, sovereign debt premia and uncertainty over the status and cost of various resolution mechanisms, e.g. bail-in bonds). However, we expect there to be a wide dispersion around this average as individual banks continue to position their balance sheets differently, and/or be subject to different regulatory capital standards (for example the so-called

‘super-equivalence’ measures in Switzerland), timeframes (for example the slower pace of Basel implementation in the US and elsewhere), and other conditions (such as ongoing financial instability across much of Europe). We expect this dispersion to remain for an extended period, or even permanently. There is nothing unsustainable or incoherent about different banks having different capital structures and different nominal costs of equity, while competing on level terms – the differences manifest as different risk/return profiles for investors (not better or worse – just different), rather than different economic cost bases. It seems that an original goal of the Basel accord – to create a level playing field for international banking by mandating standard capital ratios – is as far off as ever, and might have been a flawed endeavour from the start.



Assuming a long-run sustainable equity spread (RoE–CoE) of no more than say 2% for better performing banks, we're looking at equilibrium average returns on equity for them in the order of 9–11%, but again with the same 'structural dispersion' as underlying CoE, and more besides, given natural performance variability between banks.

Apart from the implications for internal decision-making (in pricing, investment appraisal, etc.), this 'structural dispersion' of CoE and RoE will mean that RoE will be less reliable as a comparative performance measure beyond tightly defined peer groups, or for individual banks from one period to the next. In its place we expect that investors and analysts will focus more on things like economic spread (RoE–CoE) and economic profitability (EP/assets), partly for the sake of comparability and partly in response to the general tightening of margins (i.e. they will want to track them more closely).

In the meantime, it is likely over the next few years that negative economic spreads will be common until such time as CoE subsides and the frictional restructuring costs and reversal of the pre-crisis 'supernormal asset growth' phenomenon work their way through. We suspect the continued incidence of negative spreads will continue to fuel misleading claims that the industry has been rendered uneconomic by regulation, i.e. that the problem is too much capital.

Tax

At present, the overwhelming phenomenon in the tax world is the strong public and political mood (partly recriminatory) to tax banks, without necessarily tracing through to where the ultimate incidence will fall or what the second-order impacts may be.

This will increase the risk of distortion and instability in global financial markets. Apart from the somewhat divergent approaches that are likely to emerge between different Western economies, we think the overall thrust of increasing taxes on banking will be stronger among Western economies as a bloc, relative to emerging markets, and that this will contribute to the general migration of banking activity and bank capital in that direction.

We see a future equilibrium in which banking tax regimes generally arrive at a 'maximum sustainable tax take' point, where the ultimate bearers of bank tax – customers, investors and employees essentially – have absorbed the changes and adjusted their positions and behaviours as much as they are going to.

Specifically:

- The current multiple drivers of tax reform–policy shaping, revenue raising and restitution – will dissipate in favour of the former, which is here to stay. From now on, banks will always be singled out for 'special' tax treatment. Banks have a responsibility to keep the debate centred on the policy aspects and to make a positive and balanced contribution to that debate.
- The policy shaping agenda is currently Europe-centric, but may be followed elsewhere in a second wave of tax reform.
- Any new 'incidental' bank taxes that are introduced (such as the Financial Transactions Tax) will be hard to unwind entirely as the political argument to tax banks less (and others more) will be hard to sustain.
- Proposals to remove or erode the tax deductibility of debt will not be adopted.
- Levies on bank liabilities – initially confined to Europe – may propagate to other jurisdictions as a means to influence capital structures.
- We expect a big focus on tax avoidance and 'aggressive' forms of tax planning, with public shaming being used more alongside more traditional forms of tax ruling and sanction. Boards and executives will need to make complex judgements in interpreting both the spirit and the letter of the tax code.
- The general level of corporation tax (not specific to banking), which is trending downwards globally, will settle into the 20–25% range.

The overall impact of tax reform, following a key theme of this paper, will be to favour a greater degree of equity financing of the banking sector than in the past.



We anticipate a rapid outgrowth of innovation and investment once industry finds the bandwidth.

Industry structure and business models

Banks have already started to re-evaluate their competitive positioning and business mix. There is widespread consensus in the market that this will reshape the industry in the following ways:

- overall balance sheet shrinkage
- capacity reduction and specialisation
- the emergence of a ‘super-league’ of universal banks with the resources and economies of scale to take up business given up by others and to move aggressively into new areas, and
- a migration of assets into the shadow banking sector.

Although we agree directionally with these trends, we make the following additional observations:

- We expect the balance sheet shrinkage across the market to overshoot, because it is being driven largely by the so-called ‘deleverage’ agenda in which balance sheet shrinkage is seen as a path of lesser resistance than raising fresh equity and funding in the current environment. As such, it will continue past the point where underlying economic growth resumes, up to the point where investors start to see very compelling value in putting capital back into bank assets. The inherent procyclicality of aggressive deleverage programmes will also contribute to the trend going past its equilibrium state before coming back.

- We see capacity reduction as being operational and cost – as opposed to balance sheet – related. Initially, we think it will be directed at soft-target variable costs (such as people, business lines and distribution centres) and areas that banks choose to downscale or exit due to portfolio/capital constraint considerations. For example, we hear a lot of talk about rationalisation in Fixed Income, Currency and Commodities (FICC) businesses. In these respects we think it too will overshoot the mark. In contrast, the more important, harder-to-shift, fixed-cost categories such as property and third-party supplier spend will take longer to address and be less likely to overshoot.
- While we believe cost dynamics and scale efficiencies in particular will dictate the outcome of rationalisation in high-volume, commoditised product markets (favouring the ‘super-league’ banks), elsewhere the rationalisation will be more on service quality, relationships and product specialisms.
- Although deleverage (including non-core asset sales) and regulatory arbitrage will induce a flow into shadow banking, the pace and ultimate extent of this will be less than many expect. Instead, we expect to see a greater use of non-core structures, increasingly in the form of legal vehicles (as opposed to management structures), so as to facilitate inbound equity participation as opposed to outbound asset sales.

Lastly, we anticipate a rapid outgrowth of innovation and investment catering to the new world order of shifting demographics, new trade patterns, mounting environmental and natural resource pressures, and transformed business models and commercial practices across the wider economy. We say ‘rapid’ because it is already overdue, and once industry feels the pressure of opportunity strongly enough, and finds the bandwidth, we believe it will move quickly. What is less clear is which segment or segments this will stem from: the remaining universal/pan-regional banks, the newly refocused product/regional specialists including established banks in emerging markets, or entirely new entrants. We suspect all will play a part.

We expect these forces to 'echo' through the system for an extended period of time before economic fundamentals eventually dominate and an equilibrium price pattern is established.

Product offerings and pricing

This is where the market will be most acutely disrupted and, we think, where a new equilibrium will take longest to become established. On pricing, we see two key sources of disruption:

- The shifting foundations of capital, funding and liquidity costs. As they adapt to the new funding arrangements over the next two to three years, we expect individual banks to revisit their pricing models, and to develop pricing strategies accordingly, in relation to their target markets.
- While we agree directionally with the consensus view about the need and likelihood of market capacity reduction and specialisation, the potential for overcorrection and distortion in this – particularly where driven by RWA optimisation as opposed to competitive tension and underlying customer demand – will have a substantial bearing on market prices and profit margins, both overall and by product.

We expect these forces to 'echo' through the system for an extended period of time before economic fundamentals eventually dominate and an equilibrium price pattern is established. By the time that happens, we expect inter-product price distortions to have dissipated more or less entirely (so, back to pre-crisis relativities) and absolute price levels to have settled somewhat higher (say 100–125 bps on funded products; 25–50 bps on derivatives) than the pre-boom/pre-crisis levels. This will reflect structurally higher funding and liquidity

costs, but structurally lower operating costs. Capital should ultimately not feature in this equation.

If the long-run impact on pricing will be muted, the impact on actual product offerings will be more pronounced, underscored by a trend towards simplification and a reversion to satisfying basic underlying customer needs. This will drive both the rationalisation of legacy products and the characteristics of new products.

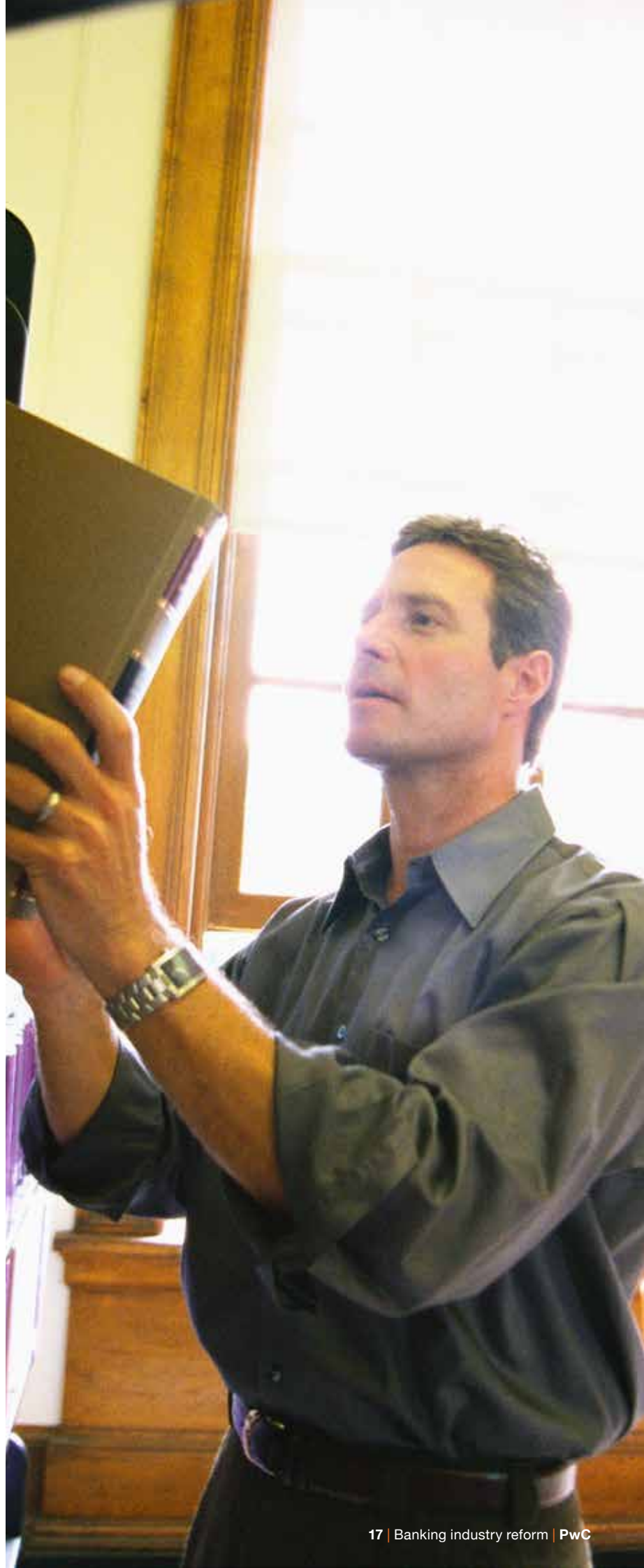
In terms of the legacy, at two ends of a spectrum there are:

- products that are essentially unaffected, and
- products that have already disappeared and won't be missed.

The range in-between, comprising products that have been rendered unattractive on the supply side but for which there remains strong underlying customer demand, will be the focus of most re-engineering activity in the short to medium term. This will be bank – as opposed to customer – driven as banks try to minimise the RWA load, or recalibrate to other new regulations, with least disruption or cost to themselves and their customers.

Looking beyond the legacy, we anticipate an array of products and services that have not really existed before, but for which evolving global business, economic, regulatory, demographic and environmental conditions will generate new demand and opportunities for innovation. Again this will be bank driven to begin with but in the longer term we see this becoming increasingly customer-driven,

arising from the need for financial services to help unlock the latent economic growth potential in new markets and technologies; for financial instruments to help create, clear and hedge the market for an increasingly scarce, contested and volatile stock of precious commodities; and for ways to help finance the upfront capital costs of dealing with major macro-environmental trends such as climate change and ageing populations.





We do not believe banks should become honest plodders again – through innovation and agility they can take up the challenges and opportunities in a bold, positive and even exciting way.

Conduct and reputation

So far we have focused mainly on the financial and fiscal aspects of industry reform. But there is also a moral dimension that, through a coalescence of broader stakeholder interests, has arguably become the true driving force behind industry reform. We refer to a political/regulatory/fiscal complex, acting on behalf of wider society, in conjunction with other pressure groups and even shareholders themselves (the term ‘shareholder spring’ has emerged in this context) to force change. Following this logic, banks will continue to face stakeholder pressures and interventions, will continue to pay a premium for funding, and will continue to underperform in equity markets until they are judged by wider society to have been fully and permanently ‘reformed’.

As a result, we believe a new equilibrium in conduct is in prospect, which will have as a core foundation the principle that doing the right thing by your stakeholders is not only a pre-condition,

but is also a means to doing the best thing by your shareholders. There is nothing new in this principle of enlightened self-interest: other industries and indeed some banks have travelled this route before, notably in the retail and consumer goods, food and beverage sectors, where customer attitudes are key.

Our expectation is that this enlightened self-interest will induce banks as a first step to focus on restoring the confidence of all of their stakeholders, as a means to renew their licence to innovate and grow; to raise finance; to take risk; to price commercially; to generate profits; and to pay dividends. The hygiene factors of transparency, integrity and resilience are the key ingredients here, we believe. But to be clear, we’re not advocating that banks should all become honest plodders again. Through innovation and agility in new markets, new economic models, new products and new ways of tackling some of the world’s toughest economic challenges, we believe they can (with permission) take up this challenge and opportunity in a bold, positive, even exciting way.

The time will come when banking executives and staff are again viewed as deserving recipients of performance awards.

Bonuses

Since it is bankers under discussion, we can't conclude before making a comment on bonuses. We believe that the time will come when banking executives and staff are again viewed as deserving recipients of performance awards, perhaps no more than in other commercially driven organisations, but no less either. The key shift we envisage – actually the continuation of a trend already started – is that the basis of incentivisation and reward will broaden out from being dominated by short-term financial performance to something more balanced. As part of this, we also believe that the principle of enlightened self interest, as previously discussed, will gradually permeate through bank cultures and, ultimately, into performance objectives and evaluation criteria.

A key issue with bonuses (not just in banking) is their asymmetry and, hence, inducement to risk-taking and leverage. These are both temptations in which banking has offered ample opportunity for indulgence, and a range of solutions and remedies have been put forward to

address this. We believe these have had limited success, so in a future equilibrium we see complex risk-adjusted performance metrics, equity participation, bonus clawbacks and the like being replaced or at least tempered with more traditional behaviourally driven performance incentives involving balanced scorecards, salary reviews, promotions and simple cash bonuses. We also see the balance between fixed and variable pay shifting towards cross-industry norms.

A lot will ride on the design of the scorecards and the integrity, sophistication and completeness of the processes for populating them. In other words, this is where the sophistication and complexity should be, not in the structuring of the awards that they drive.



Conclusion

While the range of possible future outcomes in a volatile environment is complex, a number of clear themes emerge from our analysis.

- A period of capacity reduction and specialisation is under way, but industry reform is the catalyst for this, not the cause of it. The true cause is that banks became overstretched and overgeared during the boom years. The reversal of that position, while undoubtedly painful, is now both natural and desirable.
- The good news is that the fundamental customer need for banking products and services has not disappeared, and the opportunity in the long run to service that need profitably has not gone away either. While there are costs, these are largely frictional and will either work through or be absorbed in the market. Neither banking overall, nor any part of it for which there is legitimate customer need, have become uneconomic.
- As with any change, there will be relative winners and losers. The winners will be those that manage through this transition most effectively, with sights clearly set on longer term goals, and emerge in the new equilibrium with their franchises and balance sheets in best shape. In a nutshell, there is everything to play for.

Against this backdrop, it is crucial for banks to develop a clear vision of the future equilibrium and their place in it, and to tailor their strategies, business models, and customer and investor propositions accordingly. But more importantly still, since this vision will

not be accurate – the landscape will keep changing – banks should invest heavily in creating and managing ‘real options’, because underlying volatility will put a very substantial premium on optionality.

But first they need to qualify to play – not just in terms of regulatory approval, but by renewing their licences in a much broader sense – in the eyes of regulators of course, but also investors, rating agencies, customers, policymakers and ultimately the public at large. Three stakeholder groups warrant particular attention:

- *Investors* because they will need convincing that the new equilibrium of leverage, cost of equity and return on equity is both inevitable and does not leave them worse off (probably better) in value terms.
- *The wider public* because it is their attitude that is fuelling the political and regulatory agenda. Banks cannot resume control of their destinies without first restoring the confidence of the societies they serve.
- *Customers* because, while investor and public endorsements are crucial thresholds into the new equilibrium, it is only customer endorsement, through their enthusiastic take-up of bank products and services that will sustain them in that equilibrium.

In the short term, we think it is crucial that banks recalibrate their economic models, performance targets and pricing formulas to the new economic realities. Clearly distinguishing between ‘economic’ and ‘idiosyncratic’ cost factors will help to guide them in this. They should be wary of allowing regulatory proxies such as RWAs to drive their decisions.

When it comes to portfolio optimisation, the first instinct should be to avoid it, i.e. to alleviate whatever constraint is causing the need to optimise in the first place. But recognising the reality of constraints in the short term, it is crucial that optimisation criteria are not distorted by regulatory capital formulations and also that they take full account of longer term strategic and commercial considerations.

To conclude, we think a radical rethink of strategy and decision-making is called for. This rethink needs to be framed by a strong sense of a new equilibrium, the economic relationships (macro and micro) that will govern it, the dynamics that will bring it about, and the transitional states it will go through. We hope through this paper to have triggered some thoughts on all of these fronts. Of course, individual banks need to be realistic about the nature and extent of the legacy that many of them still need to deal with (overstretched business models, inflated costs, underperforming assets, poor systems, tarnished reputations, etc.), but we believe banks should address these issues with a mindset that there is a future in which they can prosper, and in a way that clearly and demonstrably takes them in that direction.

For more in-depth discussions on the topics raised in this paper, please refer to our more detailed analysis in ‘The New Equilibrium: Part 2’ online at www.pwc.com/banking

Banks became over stretched and overgeared during the boom years. The reversal of that position, while undoubtedly painful, is now both natural and desirable.

Contacts

To discuss any of the issues raised in this paper, please speak to your usual PwC contact, or one of the following authors:

Miles Kennedy

Phone: +44 (0) 207 212 4440

Email: miles.kennedy@uk.pwc.com

Bob Sullivan, PwC Global Banking and Capital Markets Leader

Phone: +1 646 471 8388

Email: robert.p.sullivan@us.pwc.com

Richard Barfield, Risk and Regulation

Phone: +44 (0) 207 804 6658

Email: richard.barfield@uk.pwc.com

Matthew Barling, Tax

Phone: +44 (0) 207 212 5544

Email: matthew.barling@uk.pwc.com

Nick Forrest, Economics

Phone: +44 (0) 207 804 5695

Email: nick.forrest@uk.pwc.com

Tom Gosling, Remuneration

Phone: +44 (0) 207 212 3973

Email: tom.gosling@uk.pwc.com

Christopher Jackson, Valuation

Phone: +44 (0) 207 212 3832

Email: christopher.jackson@uk.pwc.com

Justin Malta, Strategy

Phone: +44 (0) 207 213 8246

Email: justin.a.malta@uk.pwc.com

Stefano Mortali, Product and Pricing

Phone: +44 (0) 207 213 2033

Email: stefano.m.mortali@uk.pwc.com

Eduardo Viegas, Product and Pricing

Phone: +44 (0) 207 804 2510

Email: eduardo.m.viegas@uk.pwc.com

Jon Williams, Sustainability

Phone: +44 (0) 207 804 3978

Email: jon.d.williams@uk.pwc.com

For more information on the New Equilibrium, or other PwC financial services programmes, please contact Áine Bryn, Global Financial Services Marketing Leader, on +44 207 212 8839, or aine.bryn@uk.pwc.com.

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