HOW CAPITAL PLANNING CAN TRANSFORM BANK STRATEGY

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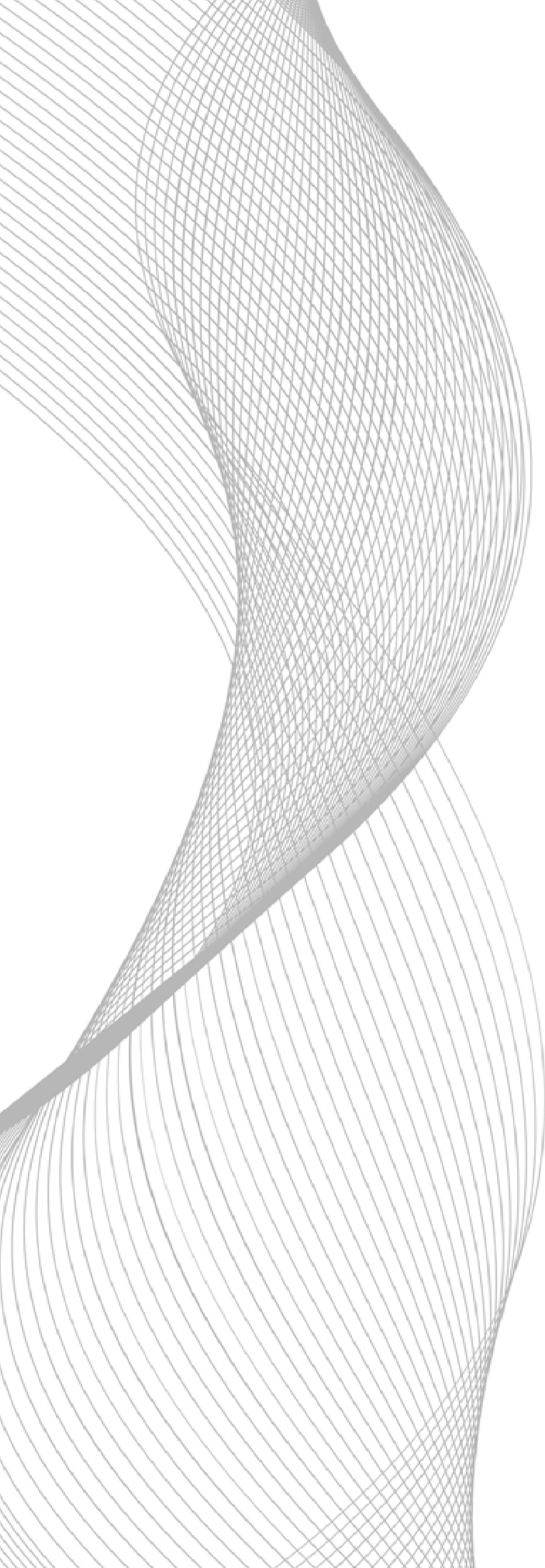


Banks who align strategy with capital planning are better positioned to outperform their peers. Executives can evaluate individual strategic options in capital markets by looking at their marginal impact on overall performance relative to their cost.

In this report, Capco discusses how scenario-based planning combined with common performance metrics can help executives assess strategic choices.

STRATEGY ROADMAPS AND PIVOT POINTS

As we continue through Q2 of 2019, global banks are formulating capital plans for the upcoming year, with an eye towards investor guidance. While capital plans are inherently tied to firm strategies, they are subject to regulatory approval. To manage market expectations, banks periodically provide forward guidance regarding capital plans to market participants. In tandem with this recurring flow of events, the Basel Committee on Banking Supervision (BCBS) published Basel III monitoring requirements during 2018, for subsequent review by US regulators. Under this guidance, banks will disclose capital, leverage and liquidity levels for broad review, as bounded by regulatory minimums.

Bank executives face the challenge of aligning strategy with capital allocation. When deciding profit distribution, management has a finite set of choices and number of constituent interests to serve. Executives can choose a combination of the following: dividend payout, stock buyback, earnings retention, capital expenditure allocation or debt retirement. From one quarter to the next, senior management selects from these options. While they proceed, investors monitor reported metrics and adjust their market positions. Therefore, common equity levels which could trigger capital constraints should inform choices in capital planning, as they send a signal to bank investors regarding the firm's overall health.

From a capital markets perspective, market and counterparty risk are key measures which inform required capital levels. Banks with sizable trading desk operations are subject to Fundamental Review of the Trading Book (FRTB) capital requirements. Capco has worked with several banks in FRTB initiatives, involving both the standardized (SA) and internal models (IMA) approaches for assessing capital. Banks are required to report trading desk capital under SA and may apply for IMA under certain conditions.

Banks preparing for SA and IMA often plan on a multi-year horizon, given a regulatory date of 2022 for IMA. In several banks, SA and IMA preparation has been framed from both tactical and strategic perspectives, impacting capital planning and related activities within the bank. Both SA and IMA can fall under a general strategy roadmap:

SHORT TERM TACTICAL	LONG TERM STRATEGIC
• Deprioritize activities in advanced approaches and focus on standardized approaches • Focus on data: market, reference and others • Up-tier clients on products which do not inflate capital requirements • Automate capital calculation and support future state	• Focus on financial benefits from improved return on equity and portfolio concentration management • Manage strategic impact, including returns management with pricing and platform buildout to support more flexible pricing • Assess risk impact when pricing deals and plan capital accordingly

Executing this roadmap requires that bank executives understand the likely capital impact of IMA vs. SA, relative to the cost of achieving IMA. This capital impact, as measured by changes in risk-weighted assets (RWA), helps inform strategic decisions from both top- and bottom-line perspectives. While the Collins Amendment currently sets SA as a capital floor, several banks have made substantial investments in advanced approaches, including IMA as a forward-looking effort. These efforts have a commensurate impact on leverage and liquidity levels as well.

This paper presents a simplified version of an RWA impact model used in capital planning. It discusses use case scenarios and how to successfully put the approach into practice. Banks can leverage this model to estimate the capital impact driven by their initiatives.

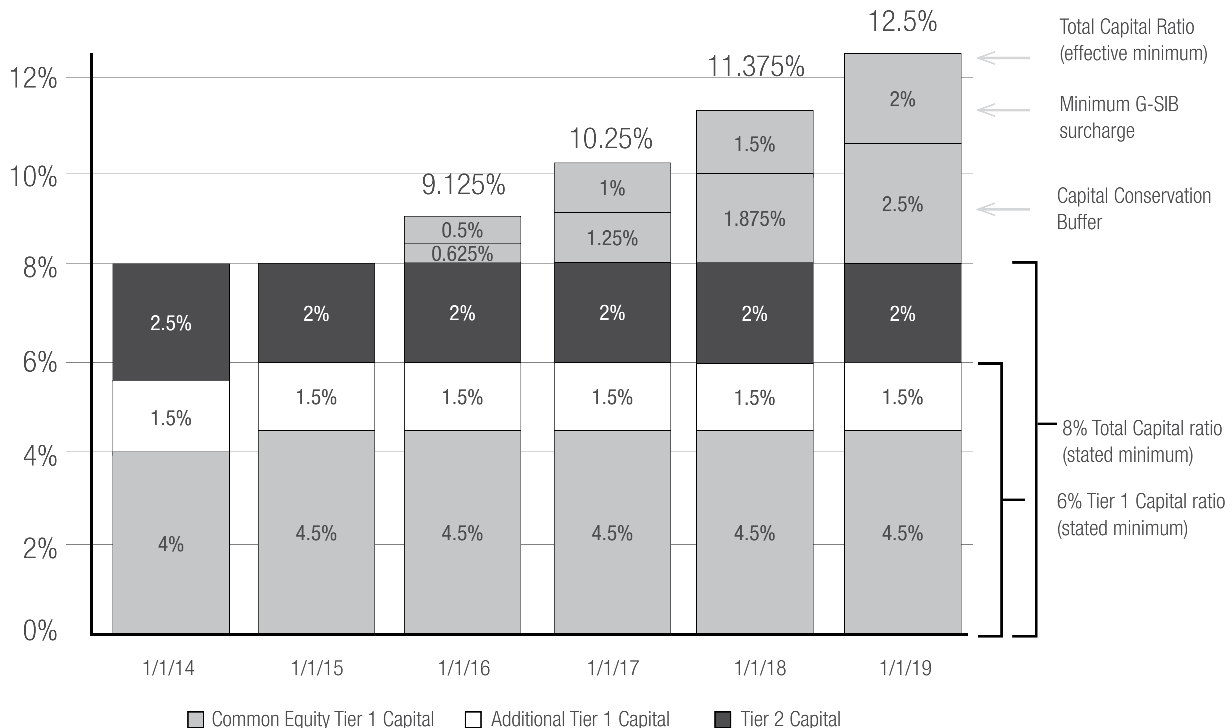
SELECTION OF CAPITAL MEASUREMENT

When discussing capital requirements, it's helpful to start by defining how capital is measured. In general, banks must maintain a minimum total capital ratio; components of this ratio vary depending on size and complexity of the organization. Global systemically important banks, or G-SIBs, have the highest capital requirements. Some essential ideas to consider include:

- Bank capital requirements are structured in tiers, which reflect priority in loss absorption, systemic risk and other considerations
- Common equity tier 1 (CET1) refers to the capital level associated with the bank's common stock; common equity capital is the first tier impacted in the event of losses
- Tiers may include a minimum CET1, a capital conservation buffer, a counter-cyclical buffer and a G-SIB buffer
- For G-SIBs, these capital tiers are being phased in as shown below through 2019
- CET1 is often used as a measure of capitalization levels for planning purposes since other tiers have instrument-specific caps (e.g., TruPS), funding choices can introduce constraints (SIVs) and publicly traded equities are readily priced

While stress testing is an essential consideration in capital planning, we defer its impact on capital measure to a different discussion. For simplicity, we're considering a base case in capital measure; practical application for capital planning would need to consider adverse and severely adverse market conditions under the aegis of CCAR/DFAST. For this example, we want to focus on capital levels under business as usual (BAU) conditions, as stressed capital planning can take us into the realm of resolution and recovery planning (RRP).

BASEL III TOTAL CAPITAL WITH G-SIB TRANSITION



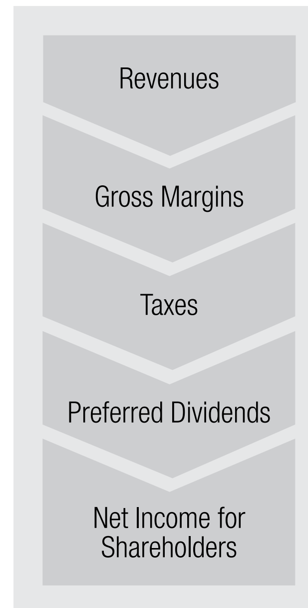
Figures reflect aggregate Fed/OCC guidance across the range of banks up to G-SIB

RWA AND PROFITABILITY

Banks monitor capital levels as part of ongoing operations, and failure to meet minimum levels can result in adverse consequences. However, dollars allocated to capital reserves represent dollars not allocated to profitable activities. Multiple considerations come into play as executives manage this trade-off:

- RWA is the basis for determining individual and aggregate capital charges; under both SA and IMA, RWA is increased to reflect increased position and portfolio risk
- Product and pricing strategy directly impact RWA in that, as trading desks carry more risk on their books, their RWA and capital charges go up as well
- Return on equity (ROE) and its variants can be viewed as the contribution of business line profitability available to common shareholders
- As the bank changes strategy, both revenues and costs are impacted; both must be considered to evaluate profitability and impact on capital
- Given all this, senior management must balance profitability targets across business lines against the cost of capital allocation when deciding on a strategy

SIMPLIFIED CAPITAL CONTRIBUTION



Impact of profitability on CET1 is determined by executive decision and regulatory mandate

Reserves excluded per Additional Tier 1 definition

SCENARIO-BASED CAPITAL PLANNING

Any assessment of capital planning would need to consider strategy choices and managerial levers, then should be measured by common financial metrics. It should be framed in terms of scenarios, to make an assessment outcome actionable, and capable of being projected over a relevant time horizon. Below is a simple model for estimating capital impact, with several target scenarios for evaluation:

Capital strategy impact on RWA

Let's assume that we have a specific strategy in play, with a known impact on incremental revenue and expenses, and that we're confident about strategic execution. Holding funding choices constant, if we want to hit a target equity return, how must our risk profile change?

Target scenario

- If we want to hit a target ROE, how much must RWA change?

Capital Strategy Impact on RWA			
	Current Quarter		Future Quarter
Revenue	1		1
Strategy Roadmap			0.01
Total Revenue	1		1.01
Expenses	0.76		0.7
Strategy Roadmap			0.005
Total Expenses	0.76		0.705
PTPP	0.24		0.305
NIAT	0.18		0.23
NIAC	0.16		0.21
RWA Based Equity Allocation (CET1)	2.49		2.06
ROTCE	6.51%		10.00%
Target RWA			-17%

All financial projections and ratios are for illustration purposes only and do not reflect any specific firm

SCENARIO-BASED CAPITAL PLANNING CONTINUED

Assumptions	
Tax Rate	25%
Preferred Rate	10%
Target ROTCE	10%
OER	70%

Definitions	
PTPP	Pre-Tax Pre-Provision Profit
NIAT	Net Income after Taxes
NIAC	Net Income Available for Common Stock
ROTCE	Return on Average Tangible Common Equity
CET1	Common equity Tier 1 Capital / RWA
OER	Operating Expense Ratio
CET1 for $Rev	Total CET1 / Total Revenue

NOTES ON CAPITAL ALLOCATION MODEL

- RWA target represents adjustment required for a bank to hit their ROE target once net income impacts are realized
- Revenue and expenses are normalized on a single-dollar basis to align with capital contribution to total common equity
- Revenue and expense adjustments represent the impact of the strategy roadmap
- Revenue and expense adjustments are projected separately or in tandem to estimate the total impact of strategy roadmap revenue spend. Certain rules of thumb are used to simplify projections

To hit an aggressive ROE target based off current state, note the large drop in RWA required in this example. Such a drop may suggest that the targeted move in ROE is challenging. Aside from the uncharacteristically large RWA reduction, this example illustrates the importance of strategy ROI and time horizon in capital planning.

SCENARIO-BASED CAPITAL PLANNING CONTINUED

Capital strategy impact on ROE

Now let's assume that conditions on the ground change, and we don't see the movement in RWA as originally estimated as a result of our execution. How does this impact return on equity?

Target scenario

- If revenue and expenses run as projected, but our RWA adjustment is less than expected, how does this impact ROE?

Capital Strategy Impact on ROE			
	Current Quarter		Future Quarter
Revenue	1		1
Strategy Roadmap			0.01
Total Revenue	1		1.01
Expenses	0.76		0.7
Strategy Roadmap			0.005
Total Expenses	0.76		0.705
PTPP	0.24		0.305
NIAT	0.18		0.23
NIAC	0.16		0.21
RWA Based Equity Allocation (CET1)	2.49		2.19
ROTCE	6.51%		9.40%
Target RWA			-12%

All financial projections and ratios are for illustration purposes only and do not reflect any specific firm

Not surprisingly, when our RWA adjustment is less than anticipated, we can expect to not hit our ROE target. An RWA adjustment off-target could happen for any of several reasons, some of which may be beyond the reach of decision-makers. In such a case, bank leadership will find it advantageous to proactively manage expectations with investors.

SCENARIO-BASED CAPITAL PLANNING CONTINUED

Capital strategy cost to hit targets

Now let's assume that we might want to change strategy. We have specific financial metrics and want to estimate the amount we should spend on capital expenditure or specific initiatives.

Target scenario

- If we have RWA, ROE and revenue targets, and are confident we'll hit all, what's the most we can spend on strategy?

Capital Strategy Cost to Hit Targets			
	Current Quarter		**Future Quarter**
Revenue	1		1
Strategy Roadmap			0.01
Total Revenue	1		1.01
Expenses	0.76		0.7
Strategy Roadmap			0.007
Total Expenses	0.76		0.71
PTPP	0.24		0.32
NIAT	0.18		0.24
NIAC	0.16		0.21
RWA Based Equity Allocation (CET1)	2.49		2.14
ROTCE	6.51%		10.00%
Target RWA			-14%

All financial projections and ratios are for illustration purposes only and do not reflect any specific firm

Once we separate the cost of a strategic initiative from its measurable benefits, we can assess whether it's worth the cost. Many organizations develop a 'rule of thumb' for evaluating specific initiatives from a capital perspective. For example, for an initiative to be considered, its ratio of marginal revenue relative to expenses must exceed a certain multiple. This guideline can be easily included in scenario-based capital planning.

BRINGING IT ALL TOGETHER

Bank executives face multiple challenges in strategic execution - capital planning is one tool in the executive toolkit. While this is true for many industries, banks are unique in their capital structures and their roles as financial intermediaries. Bank management must balance the goals of multiple constituents, so insight regarding effectiveness of strategy choices can be very useful. Discussed here is a simple way to relate ROE with P&L. Practical application requires customization to match a bank's unique situation, including organizational structure, funding choices and other considerations. Note that while this paper focuses on capital markets activities, firms can use a similar approach for banking as well, which supports the use of equity impact as a performance metric.

To share comments or discuss how capital planning can benefit your organization, contact the following:

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ABOUT CAPCO

Capco is a global technology and management consultancy dedicated to the financial services industry. Our professionals combine innovative thinking with unrivalled industry knowledge to offer our clients consulting expertise, complex technology and package integration, transformation delivery, and managed services, to move their organizations forward.

Through our collaborative and efficient approach, we help our clients successfully innovate, increase revenue, manage risk and regulatory change, reduce costs, and enhance controls. We specialize primarily in banking, capital markets, wealth and investment management, finance, risk & compliance and insurance. We also have an energy consulting practice in the US. We serve our clients from offices in leading financial centers across the Americas, Europe, and Asia Pacific.

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