Banking industry in strategic trap between short-term regulatory compliance and long-term value creation
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Preface

The zeb/value compass 2012 is zeb’s third study on value creation in the banking industry. Like the 2010 and 2011 editions, this report aims at analyzing value creation in the banking industry and identifying current trends and best practices. This edition gives an update on the analyses of the previous years and adds another key element to a successful TSR strategy.

The study is structured along the core elements of a value generating TSR journey (see Fig. 1). Chapter 1 describes the market environment as well as the TSR development of the global top 100 banks as the basis for banks’ TSR strategies. Chapter two investigates banks’ underlying value drivers with the help of our empirical value explanation model.

However, without proper investor communication a bank may deliver upon its targets and yet fall short of its TSR performance. In order to complete the TSR journey and fully reap the benefits of its efforts, a bank needs to proactively communicate with investors and inform them about its approach/business model to generate value. Against this background, chapter 3 investigates the disclosure standards of leading global financial institutions with respect to the key content and style of presentation of their value reporting. In the last chapter, our findings

Fig. 1: TSR Journey
are summarized and management implications derived. The aftermath of the financial crisis in the form of tighter regulations on the one side and high government debt levels combined with a low interest rate environment on the other side have changed the rules of the game in banking. Banks face the twin challenge of reforming the business model and complying with higher regulatory requirements at the same time. These new rules of the game have caught many banks in a strategic trap where banks focus on regulatory compliance only. Therefore, we will discuss this strategic trap in more detail in chapter 4 and illustrate ways out of it.

**News: zeb/market flash out now!**

The zeb/value compass at hand is an annual publication which investigates the value creation of the global top 100 banks in great detail. To keep our clients informed about the latest developments regarding value creation in the financial industry throughout the year, we have augmented the zeb/value compass with the quarterly zeb/market flash which focuses on market developments of the respective last quarter. The zeb/market flash provides a thorough assessment of the latest developments of the global banking market. The compact quarterly publication investigates the capital market performance of the global banking sector during the last three months as well as changes in the main drivers of international banking and the corresponding economic environment.
Executive Summary

During the last two years the rules of the game in banking have changed substantially. Due to tighter regulation, liquidity and capital have become true bottlenecks rendering some old, capital-intense business models unsustainable. Banks are struggling to create value and often lack a strategic vision of how to reorganize the business model.

In this context, the third zeb/value compass gives a comprehensive view on value creation in the global banking industry based on empirical analyses and expert interviews with the senior management of leading national and international financial institutions. The main results of this year’s edition of the zeb/value compass are:

/ The global banking industry showed a solid TSR performance of 7.3% in the first half of 2012 in a friendly market environment after a very poor TSR performance in 2011 of -23.6%.
/ Our analysis of the underlying factors shows the increasing importance of a holistic value management in the current difficult economic climate and in light of the increasing regulatory pressure. This can be shown with the help of the zeb/value explanation model which takes all relevant value dimensions and constraints into consideration and has an explanatory power of 61.9%. Thus, the $R^2$ is far greater than the one of a simple RoE model which can only explain 8.7% of the observations.
/ A deeper look into the disclosure reveals that while many banks have started to implement holistic value generation frameworks, most of them still have not yet entered the last part of the TSR journey, namely the pro-active communication with investors via consistent and transparent disclosure. In this respect even the largest global banks fail to present a holistic view on their value generation approach.
/ Discussions with senior managers also reveal that dramatic changes in the global banking industry have left the majority of

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1 See last year’s zeb/value compass for a more detailed discussion.
banks with many operational challenges but no clear strategic vision. While most bankers agree that the old, capital-intense business models no longer work for the vast majority of banks, few of them actually have a clear vision of what their future business model will look like. The immense operational workload and regulatory pressure poses the threat that banks get caught in a strategic trap: Due to low profitability and regulatory pressure banks focus on regulatory compliance only and try to run the old business model in a Basel-III-compliant way. By doing so, they focus their activities on the capital-efficient businesses, such as, for example, retail banking or fee-based activities. Given the current market environment with low interest rates and increased competition for these activities, margins erode and profitability declines further. Banks need to cut back activities even more to meet regulatory compliance. The vicious circle continues driving banks into the strategic trap as they lose sight of what really matters: sustainable value creation.
TSR development of global top 100 banks

Significant losses in market capitalization during European debt crisis

Having only recently recovered from the financial crisis in 2008, the global banking industry suffered another hit in 2011 when the European debt crisis emerged. The market capitalization of the global banking industry declined by 25% in 2011 as banks were facing the European debt crisis, tighter regulatory requirements and unfavorable market conditions with low interest rates leading to profitability, liquidity and capitalization issues. The first half of 2012 saw a small recovery of approximately 8% driven by, among others, some positive signals from the European debt crisis.

Banking sector still unattractive for investors

In 2011, few industries were able to generate a positive return for their investors (see Fig. 3) but the banking industry was not among them. Instead, it was the second-worst performing industry in 2011 with an average return of -23.6%. Although the banking sector recovered in the first half of 2012, from a long-term...
perspective it remains unattractive for strategic investors with an average return of only 4.8% p.a. in the period from 2003 to the first half of 2012. In the same time, the global banking industry had the second highest standard deviation of return (30.5%) of all industries. This low return/high risk profile clearly poses a challenge to banks and highlights the need for banks to carefully reconsider their TSR strategy.

Investigating the top 100 banks in our sample in more detail reveals that the TSR development in 2011 was very heterogeneous (see Fig. 4). Despite a very volatile market environment, some banks managed to convince investors and generate returns of about 30% during 2011 while the low performers lost more than 60% of their value in the same period. It is striking that most top performers (in 2011
as well as in the long term) come from developing countries like Indonesia, China or Russia. On the other hand, all ten low performers in Fig. 4 come from mature markets, namely Europe and the U.S. It seems that being located in growth/mature markets or being exposed to the European debt crisis is a major driver of TSR performance.

A closer analysis of the banks located in growth regions illustrates, however, that GDP growth in the home market alone is not sufficient to explain a positive TSR performance neither in the short nor in the long term. A look at the TSR performance of Chinese banks in 2011 (see Fig. 5) reveals that their development is as heterogeneous as within the entire industry despite operating in the same market (with very little foreign operations) and thus under the same economic environment. While some Chinese banks performed well in 2011 with TSR growth rates from 5 to 20%, others underperformed with negative growth rates of -25%. Hence, GDP growth might have a positive influence on TSR development but it is

GDP growth is not the main driver of TSR in growth regions

A closer analysis of the banks located in growth regions illustrates, however, that GDP growth in the home market alone is not sufficient to explain a positive TSR performance neither in the short nor in the long term. A look at the TSR performance of Chinese banks in 2011 (see Fig. 5) reveals that their development is as heterogeneous as within the entire industry despite operating in the same market (with very little foreign operations) and thus under the same economic environment. While some Chinese banks performed well in 2011 with TSR growth rates from 5 to 20%, others underperformed with negative growth rates of -25%. Hence, GDP growth might have a positive influence on TSR development but it is
not its only determinant. These findings are confirmed in the long-term perspective. When plotting long-term TSR performance of banks located in growth regions against the long-term GDP growth of those regions, no significant correlation between GDP growth and TSR performance can be found (see Fig. 5). Hence, the equity puzzle/value creation puzzle cannot be solved that easily.

Low performers impacted by debt crisis in short-term

Having a closer look at the long-term TSR low performers indicates that being located in the U.S. or Europe, however, seemed to have an influence on TSR performance at least in the short term because of the European debt crisis. An analysis of the value-weighted TSR of the 10 low performers compared to the inverted PIIGSs 5y CDS spreads reveals a high correlation between the widening of CDS spreads and the low performers’ TSR (see Fig. 6). Although there is an undeniable effect of the debt crisis on European and U.S. banks in the short term, this effect is negligible in the long run. A closer look at the long-term TSR performance of the 10 low performers shows that their TSRs are in constant “free fall” since the summer of 2007. There must have been more fundamental factors than the debt crisis at work. Therefore, we will investigate banks’ business models a bit more in detail in the next section.
National commercial banks are outperforming

As location alone cannot explain TSR performance, the question arises whether some business models were able to generate more value than others. By sorting the top 100 banks into 4 clusters according to their business models (see Fig. 7) it becomes apparent that especially international commercial banks and universal banks are facing serious challenges since the financial crisis.

National commercial banks on the other hand did relatively well. Especially national commercial banks in growth regions have outperformed the other business models. As growth in the home market alone cannot explain their performance, questions arise of who these banks are and why they perform so well. The box below presents four examples from the global top 100 sample and sheds more light on this issue.

As a first indication one can say that despite different geographical focuses, these top performers have one or more of the following features in common. A clear focus in the business model, often centered around the home market, is a feature shared by all of the four banks. A strong branch network and a high market share obviously seems to be beneficial, too. Finally, conservative risk profiles with healthy balance sheets and solid capital bases as well as a certain degree of innovative capacity are also often observed.

Fig. 7: Business model and TSR performance
While these four banks give a first indication of the underlying value drivers, the next chapter addresses this question in more detail with the help of our zeb/value explanation model.

### Know thy competitor - Selected examples of Top TSR performers

#### Bank Central Asia

**Key facts:**
- Strong branch network and highest market share in routine banking transactions in Indonesia providing lowest cost of funding among Indonesian banks
- Healthy balance sheet with low NPL ratios and very solid liquidity buffer

**Key success factors:**
- Development of its delivery channels to further strengthen its franchise value (launch of a sharia-based banking unit, special programs for youngsters/smartphone users)
- Loan expansion strategy as a reaction to the low interest rate environment in 2011

#### HDFC Bank

**Key facts:**
- High exposure to the retail segment (core CASA ratio of 48%) provides low cost of funding
- Well diversified loan portfolio with high growth rates (most of the products > 20%)
- Solid capital base with a capital adequacy ratio of 16.2%

**Key success factors:**
- Pioneer in Indian Banking: one of the first banks that received the approval to set up a bank in the private sector in India in 1994/1995; first issuer of international debit cards in 2001
- Significant branch expansion since 2005 from 467 to 1986 branches in 2011 helped to gather savings deposits

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2 The zeb/value explanation model was presented in great detail in the first edition of the zeb/value compass in 2010.
SBERBANK

Key facts:
/ Market share: 48% of Russian total deposits provide cheap funding base, 31% in lending (consumer and corporate loans)
/ Relatively well-performing lending business with 4.8% share of NPL (2011)

Key success factors:
/ 2007-2008: Sberbank gains market share/strengthens market position in the financial crisis
/ 2009: Implementation of the Sberbank Production System based on lean production technologies (e.g. credit factory with automated CRM system)
/ 2012: Acquisition of Troika Dialog, Handelsbank SLB and Volksbank International

Garanti Bank

Key facts:
/ Market Share: #1 in debit & credit cards (15 million) and #3 in terms of branches (918) and ATMs (3,250)
/ Well-performing lending business with 2.1% share of NPL (2011)
/ Leadership in internet and mobile banking

Key success factors:
/ Technological leader – Launched Turkey’s first web-based supplier financing system, Direct Debit System with risk sharing model, Inventory Finance System & Mortgage call center
/ Launched the world’s first NFC (Near Field Communication) payment enabled SIM card in 2010
/ BBVA acquired 24.9% stake in Garanti Bank in 2010 – operate under the principle of equal partnership

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**Key data (2011)**

<table>
<thead>
<tr>
<th>SBERBANK</th>
<th>Garanti Bank</th>
</tr>
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<tbody>
<tr>
<td>Total assets (EUR bn):</td>
<td>260.246</td>
</tr>
<tr>
<td>Pre-tax profit (EUR bn):</td>
<td>1.681</td>
</tr>
<tr>
<td>Return on Equity:</td>
<td>28.2%</td>
</tr>
<tr>
<td>Employees:</td>
<td>266,187</td>
</tr>
<tr>
<td>Headquarters:</td>
<td>Moscow, Russia</td>
</tr>
<tr>
<td>TSR 2003-2011:</td>
<td>34.1%</td>
</tr>
</tbody>
</table>
[II] Explaining TSR performance

As we have shown already in the first edition of the zeb/value compass in 2010 the RoE alone cannot explain value creation. While it is certainly an important factor, explaining TSR performance is more complex. Next to other fundamental value drivers, there may also exist current trends that drive value creation. In the following sections we shed light on these factors.

Impact of performance, risk and constraints on value creation

When trying to identify the characteristics of top performers, a bundle of factors, which can be grouped into the dimensions performance, risk (constraints) and growth, needs to be considered. This is shown in Fig. 8, where banks are sorted into four clusters based on their P/B ratio. The following key observations can be made:

/ Solid performance still a must-have: Fundamental factors such as the efficient usage of capital (RoE) and assets (RoA, RoRWA) as well as a strong free cash flow are still pre-requisites for a solid TSR performance.
/ Sustainable growth without violating profitability or constraints key success factor: In addition to solid current asset growth, investors care about improving growth prospects through, for example, significant business in growth regions or a strong innovative capacity (products/channels/etc.).
/ Zero tolerance re/regulatory constraints: Top performers are less leveraged, hold more liquidity and have higher Tier 1 ratios than banks with a weaker P/B ratio. With respect to liquidity a stable long- and short-term funding base is of particular importance.
zeb/ value explanation model considers all relevant value dimensions

To formally analyze the importance of each dimension the zeb/ value explanation model can be utilized, which is based on the classical Gordon Growth valuation approach. As in previous years we find that the explanatory power of the value explanation model increases significantly when incorporating all relevant value dimensions and corresponding constraints. The $R^2$ increases to 61.9%, which is substantially more than the simple RoE approach with an $R^2$ of 8.7% (see Fig. 9).

Fig. 8: Characteristics of the banks sorted by P/B ratio

<table>
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<th>Drivers of value creation</th>
<th>Performance</th>
<th>Growth</th>
</tr>
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<tr>
<td></td>
<td>RoE</td>
<td>RoRWA</td>
</tr>
<tr>
<td>Top Quartile</td>
<td>2.95</td>
<td>23.7%</td>
</tr>
<tr>
<td>2nd Quartile</td>
<td>1.97</td>
<td>19.8%</td>
</tr>
<tr>
<td>3rd Quartile</td>
<td>1.48</td>
<td>15.7%</td>
</tr>
<tr>
<td>Bottom Quartile</td>
<td>1.11</td>
<td>11.6%</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Risk/Constraints</th>
<th>Tier 1 ratio²</th>
<th>Liquidity³</th>
<th>Leverage</th>
</tr>
</thead>
<tbody>
<tr>
<td>Top Quartile</td>
<td>2.95</td>
<td>10.6%</td>
<td>88%</td>
</tr>
<tr>
<td>2nd Quartile</td>
<td>1.97</td>
<td>10.5%</td>
<td>72%</td>
</tr>
<tr>
<td>3rd Quartile</td>
<td>1.48</td>
<td>10.5%</td>
<td>66%</td>
</tr>
<tr>
<td>Bottom Quartile</td>
<td>1.11</td>
<td>9.3%</td>
<td>58%</td>
</tr>
</tbody>
</table>

1 Values are based on years 2003 - 2011 and are value-weighted averages based on market cap. 2003 - 2011.
2 Tier 1 ratio represents proxy for Core Tier 1 ratio, for which data is not available.
3 Liquidity is defined as ratio between total customer deposits plus long term debt plus total equity to total assets at end of the year. Liquidity represents proxy for net stable funding for which data is not available.
Especially liquidity and capital constraints have become important determinants of TSR performance over the years. This can be witnessed by the substantial increase in the $R^2$, when introducing the constraints into the model and by looking at the empirical weights estimated in the model, as their relative importance has clearly grown during the sample period.

Overall, our findings formally confirm the common perception of the last two years: Capital and liquidity have become true bottlenecks. This rough market environment forces banks more than ever to focus on value creation. However, “simple” delivery is not enough. As a last step on the TSR journey banks need to proactively communicate with investors and inform them about their approach to managing value creation and constraints. Consequently, we investigate the current state of disclosure in the banking industry in the next chapter.

Fig. 9: Single factor RoE model and zeb/ value explanation model (2003 - 2011)

$y = 1.023x - 0.102$

$R^2 = 0.087$

$y = 0.8404x - 0.002$

$R^2 = 0.619$
[III] Disclosure standards as lever for value creation

Regular and transparent disclosure important to satisfy investors’ needs

Ever since the financial crisis the banking sector is experiencing a certain lack of trust by the financial markets and society at large. This has been further aggravated in 2011/2012 as countless scandals dominated the banking media coverage. Together with tightening regulatory requirements/supervision and the related question of adequate capitalization levels, banks find it harder to convince analysts and investors that they are well positioned to generate value for their owners in these turbulent economic times. A consistent and transparent reporting is thus necessary to enable analysts and investors to properly assess a bank’s value proposition. Our disclosure analysis of the leading 20 Western banks focuses on the four value-oriented dimensions identified in chapter two, namely profitability and growth as well as capital and liquidity as constraints.

Decent reporting coverage of profitability and current growth situation

As profitability has traditionally been in the focus of investors most banks cover this dimension relatively well in their reports (see Fig. 10). Most of them provide information on their revenues on group level. About three-fourths of the banks differentiate between recurring and non-recurring items. Revenue and cost drivers are covered by most of the banks – however with differing granularity.

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2 Our analysis focuses on the 1Q2012 disclosures of the leading 15 European (Source: The Banker, July 2011) and 5 US (Source: FED, March 2012) banks based on total assets. The analysis of the 1Q2012 disclosures is based on reports and IR presentations. The focus is on quarterly IR communication as this is typically in focus of investors and analysts for regular valuation as annual reports are available only with a significant time lag.
The coverage of the growth dimension is much weaker. While the growth performance of the recent past, such as, for example, new business or net new money is only reported by half of the banks, disclosure on forward-looking growth statements is even worse. General economic trends and their implications on banks’ strategies are commented by 8 banks but only 2 of them actually provide substantial content. Overall, one can conclude that banks keep their growth information rather vague and shy away from providing forward-looking growth statements, often in fear of having to provide ad hoc announcements in case these growth prospects change materially. Keeping information short and vague, however, comes at a cost, because investors who do not receive detailed, value-relevant information have to make their own assumptions. This often leads to additional uncertainty and thus a valuation discount.

Fig. 10: Disclosure of profitability measures and growth prospects
Liquidity and capital constraints insufficiently reported by most banks

As liquidity and capital have become scarce resources in recent years investors and analysts alike are keen to know whether a bank is able to obtain sufficient liquidity by itself or increasingly depends on central banks’ liquidity injections. Similarly, investors want to know a bank’s true state of capitalization. This is particularly true in light of the recent experience in Switzerland, where Credit Suisse and the Swiss National Bank had a discussion about the proper calculation of capital ratios. Therefore, liquidity and capital disclosure should not just provide the plain numbers of core ratios but also details on the structure, risks and costs of a bank’s capital and liquidity position.

Our analysis (see Fig. 11) shows that most banks provide information regarding their liquidity profile but liability categories and drill-downs are very heterogeneous, thus making comparisons very difficult. Much to our surprise, forthcoming regulatory metrics such as LCR and NSFR have not been reported very often in the Q1 2012 disclosures despite their relevance in the current business climate. Similarly, information on liquidity costs is rather scarce and incomplete. It seems that banks prefer to stay opaque despite the consequences for the valuation discount. The regulatory capital perspective is covered more solidly in most disclosures. The new Basel III Core Tier 1 ratio is reported by about two-thirds of the banks analyzed. Some of them even present a detailed reconciliation between Basel II and Basel III. The Basel III leverage ratio on the other hand is not yet reported very often. The same is true for information regarding economic capital adequacy and usage.

Overall, the liquidity and capital disclosure reveals several weaknesses as the information provision is very heterogeneous and often incomplete. As a result, this makes useful comparisons across banks impossible and is likely to force investors and analysts to make their own assumptions and approximations.
Presentation structures do not cater to investors’ needs

Besides quarterly reports and IR presentations, banks apply a variety of other instruments, such as, for example, webcasts or data download options in their disclosure frameworks, however with a very heterogeneous level of detail and scope. This is also true for the investor presentations themselves. While the profitability dimension is in general extensively covered (about 80% of the presentation), other dimensions like capital or liquidity are given very little attention.

Given our findings in chapter 2, serious weaknesses especially with respect to the value dimensions risk, growth and constraints can be observed. Clearly, a pro-active, transparent and consistent disclosure strategy can generate additional shareholder value and thus TSR if additional, explanatory information is provided for all value dimensions identified in chapter 2. In this respect, the focus should be on reporting quality rather than “pure volume”.

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**Fig. 11: Disclosure of liquidity and capital perspective**

1 Other individual liquidity-related KPIs including e.g. time to required funding, avg. funding term, % completion of funding plan, NPL, (Deposits + MTL Financing)/Loans, etc.

2 Any statement re/funding costs included in analysis (e.g. pricing of latest debt issuances)
Initiatives to improve disclosure underway

In order to remedy the identified weaknesses several initiatives on various levels are underway. One prominent example is the financial stability board, which has asked experts in May 2012 to work out a reform proposal for increasing transparency in banks’ financial reporting. The expert group has identified similar heterogeneities in banks’ financial reporting and criticizes that comparisons across banks are hardly possible. They call for a harmonization of financial reporting such that investors and analysts have better information on 1) a bank’s business models and their inherent risks, 2) a bank’s liquidity position, its sources of funding and the extent to which its assets are not available for potential funding needs and 3) the calculation of a bank’s risk-weighted assets (RWAs) and the drivers of changes in both RWAs and the bank’s regulatory capital. While these recommendations are fully in line with our findings it is recommended that the banking industry takes an active role in this reform process as it provides an unique opportunity to shape this process and align the interests of all parties involved. Otherwise it is likely that market and regulatory pressures will impose new standards on the industry and banks will simply have to comply with them.

At this point it should be noted, that investor-friendly disclosure does not necessarily imply full transparency as banks have to carefully trade-off satisfying investors’ demand for information with potential competitive disadvantages and disclosure costs. Nevertheless, we believe that disclosure standards have significant room for improvement and thus represent some unused potential for the TSR journey. This is particularly important taking the current economic conditions into account, which forces many banks to realize that their old business model is no longer sustainable for the new market environment – an issue that we address in the next chapter.

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5 See for example D. Holländer and O. Scheer, “Die Liquiditätsberichterstattung von Banken ist wenig transparent”, Börsenzeitung no. 58, 22.03.2012
[IV] Summary: The strategic trap and ways to escape

Tighter regulation aggravates challenging banking environment

During the last two years the market environment for banking has changed substantially. While 2009/2010 was mostly about a first recovery from the financial crisis, the last two years were characterized by the aftermath of the financial crisis in the form of tighter regulation as well as high government debt levels combined with a low interest rate environment. In this new business environment several business models turned out to be no longer profitable. Some capital intensive activities became unprofitable due to tighter regulation as well as capital and liquidity scarcity. Other activities were simply banned or given up by banks such as, for instance, proprietary trading. The activities that remained profitable, for example retail banking or fee-based business, face increased competition and with it pressure on margins and profitability.

Discussions on senior management level confirm these challenging conditions and reveal that many banks currently lack a clear strategic vision – either because they consider the market environment too unstable to make any forecast or because they do not have a clear idea of a functioning business model for the future market environment at all. The European debt crisis has aggravated this environment by imposing losses on the majority of banks and absorbing their capital buffers. Consequently, for many banks short-term recapitalization measures have a clear priority over investments to re-organize the business model.
Single focus on regulatory requirements drives banks into strategic trap

Given that regulatory compliance is most urgent and opportunities for acquisitions and investments into new, profitable business areas are scarce, most banks focus on ad hoc measures to comply with regulatory requirements and improve profitability. Consequently, business areas with high regulatory capital requirements are scaled down first and often in an undifferentiated manner although they might be favorable from a value creation perspective. As a result, banks try to run their old business model in a Basel III compliant way. This “quick fix” might work out in the short term but is likely to turn into a strategic trap in the long term. The focus on capital efficient business areas will lead to an increasing competition in those business areas and therefore put even more pressure on margins and profitability. As a result, banks will face even more difficulties to become profitable and fill up their capital buffers again. This in turn will force banks to engage in another round of quick fixes to meet regulatory demands – the vicious circle continues and drives banks further into the strategic trap (see Fig. 12).

Fig. 12: Strategic trap
Holistic value management needed to escape strategic trap

To escape the vicious circle described above, banks need to focus on sustainable value generation again. While regulatory compliance is certainly a binding constraint, it should be achieved by re-organizing the business model and not just by scaling down the existing business model wherever it saves a lot of capital and instead competing for more capital efficient business. A full re-organization requires a holistic value-based management framework that helps to identify which business truly contributes to sustainable value generation in the future. The holistic value-based management framework will guide the strategic re-organization as it helps banks to differentiate between value-generating and value-destroying businesses while keeping constraints (e.g. regulatory capital) under control. This is achieved by understanding the link between value creation and a bank’s KPIs with the help of a value creation model. The KPIs in turn are connected to the underlying value generators with the help of dedicated value driver trees. Once the entire chain is established and understood, banks can integrate their constraints into their planning and target setting process. This enables the management to assess the value effects of different business areas. As a result, banks’ ad hoc measures can focus primarily on value destroying business and help to find a way out of the strategic trap by shaping the new, value-generating business model.

The focus on maximizing sustainable value generation instead of maximizing capital efficiency is only possible if banks are “brave” enough to go against the mainstream of purely focusing on capital-saving activities. It also implies a certain “pain period” for the bank and its investors as regulatory compliance will not be easier in the first years. However, the sole focus on sustainable value generation will ensure a better profitability in the medium and longer term. This is particularly important in the new economic environment in which low interest rates pose additional challenges for banks’ profitability.

As these challenges are likely to last for a longer time, next year’s edition of the zeb/value compass will investigate in more detail which banks have escaped the strategic trap and which of their business models have survived. In addition we will also present the most common challenges of the new, low interest rate environment and analyze how banks managed to deal with them.
Appendix

Sample listed banks

The zeb/value compass 2012 analyzes the current state of value generation in the banking industry. To provide general and representative results, the analyses of chapters 1 and 2 are based on a large number of banking institutions worldwi- de. The overall sample includes the largest 100 banks worldwide by market capital- ization at 31/12/2011, representing 69% of market capitalization of the global banking industry. The study considers classical banks, i.e. universal and special- ized banking institutions with a high share of traditional banking services – like retail, private and corporate banking including mortgage loans, investment banking and asset management. Other financial institutions like pure credit card issuers, stock traders or specialized funds management companies are not included because their business models and therefore value drivers are quite different from most traditional banks, which easily distorts the analysis. Four types of banks are distinguished in the sample: (1) national commercial banks generating their revenues mostly from classical banking activities in growth regions, (2) national commercial banks being active in mature markets, (3) inter- national commercial banks generating a large amount of their revenues interna- tionally, and (4) universal banks that are diversified banking institutions offering a large variety of products (including investment banking) to different customers on a global scale.

For each bank, the database contains the relevant balance sheet and income statement information as well as specific stock market data and qualitative characteristics regarding the business model. Based on the raw data, specific ratios and business figures were calculated and analyzed. To eliminate currency differences between institutions, the analysis uses raw data from the annual reports based on respective national currency of each bank. Different end dates of fiscal years were adjusted. Overall, the study considers data from the last nine years (2003 to 2011).
Sample Disclosure Standards

Chapter 3 analyses the value disclosure standards of leading global financial institutions regarding key content of value reporting and the presentation style. The analyzed sample consists of the largest 15 European banks and largest 5 US-American banks by assets. The basis of the analysis were the reports and IR presentation of the 1st quarter 2012 as they are typically in focus of investors and analysts for regular valuation.

TSR

To evaluate value creation of banks, the study uses the Total Shareholder Return (TSR). The TSR represents the total return for shareholders investing in a bank as it includes all stock price changes (changes of market capitalization), dividends and changes in the capital base within a given period. For the analysis on value creation in chapter 2, the TSR calculation for each bank is based on the individual total return index in respective national currency to eliminate currency distortion, which eventually could lead to misleading results.

zeb/ value explanation model

In the zeb/ value explanation model, the effect of performance, risk and growth on the TSR is examined. Performance is calculated based on the 4-year mean of the RoE in the model. The bank-specific cost of capital is employed as a proxy for risk and growth is measured based on the average growth of net profit before tax. The model presented in this study was developed on the basis of numerous discussions of top bank and financial institutions managers. Additionally, especially the P/B model was successfully presented to the scientific community at international conferences. Top managers appreciate the intuitive approach of the model and the possibility to reconstruct the employed method.
## Definitions

<table>
<thead>
<tr>
<th>Variable</th>
<th>Definition</th>
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<tbody>
<tr>
<td>Leverage ratio</td>
<td>Leverage ratio indicates the ratio between average total assets and average total equity</td>
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<tr>
<td>Liquidity</td>
<td>Liquidity is defined as the ratio of total customer deposits plus long-term debt plus total equity to total assets at end of the year</td>
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<tr>
<td>P/B ratio</td>
<td>Price to Book ratio – Proxy for the current valuation of a bank relative to its book value</td>
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<tr>
<td>RoA</td>
<td>Return on Assets (RoA) is defined as the ratio between income before income tax expenses and average total assets</td>
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<tr>
<td>RoE</td>
<td>Pre-tax Return on Equity (RoE) is defined as the ratio between income before income tax expenses and average total equity; only banks with a complete data set are considered</td>
</tr>
<tr>
<td>RoRWA</td>
<td>Return on Risk-weighted Assets (RoRWA) is defined as the ratio between income before tax expenses and risk-weighted assets; only banks with a complete data set are considered</td>
</tr>
<tr>
<td>Tier 1 ratio</td>
<td>Tier 1 ratio is calculated as total Tier 1 capital divided by total risk-weighted assets</td>
</tr>
<tr>
<td>TSR</td>
<td>Total return of shareholders of a bank including all stock price changes (changes of market capitalization), dividends and changes of capital base within a given period</td>
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About us

zeb/

zeb/rolfes.schierenbeck.associates is a management consultancy specializing in the financial services sector with 17 offices in Germany, Austria, Czech Republic, Denmark, Hungary, Italy, Luxembourg, Norway, Poland, Sweden, Switzerland and Ukraine. With more than 800 employees and several subsidiaries, zeb/ is among the leading consulting firms for banks, insurance companies and other financial service providers.

Our successful consulting concepts are founded on excellent methodical competence and the in-depth sector knowledge of our consultants. For several years, the zeb/ VBM team has successfully accompanied leading German and international banks in top-management-sponsored projects on value based management. For all our projects, we bring together specialists in the fields of VBM methodology, analytics, reporting and process management to substantiate our integrated approach on value based management. Our long-standing experience in the implementation of specialized IT solutions adds further to our comprehensive VBM expertise.

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Banking industry in strategic trap between short-term regulatory compliance and long-term value creation

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