Banking governance, financial crisis and structural challenges – the microlevel perspective

8th ESDN Workshop

Volker Abel

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<table>
<thead>
<tr>
<th></th>
<th>Title</th>
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<tbody>
<tr>
<td>1</td>
<td>Current state of the banking industry and lessons learned from the crisis</td>
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<tr>
<td>2</td>
<td>Sustainability in banking – Fundamental change or just a tactical move?</td>
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<td>3</td>
<td>The road ahead – Future sustainability in banking</td>
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Banking industry has not been attractive for investors during the last 10 years – low TSR performance and high standard deviation

Total shareholder return (TSR) of banking sector compared to other sectors

Market capitalisation of banking sector increased from 2008 to 2010, but a considerable part of the gain was lost in 2011 again

Long-term performance rather weak with an avg. p.a. return of ~4.8%. In fact, banking industry is significantly behind all other industries

While investors obtained lower return than average, they had a higher risk (in terms of standard deviation) when investing in the banking sector

1) All total shareholder returns (TSR) are based on Thomson Reuters Datastream global industry index (market cap. weighted). TSR includes all capital gains and free cash flow yields for one period; 2) Banking sector TSR based on Thomson Reuters Datastream global industry index (market cap. weighted) and may deviate from Bloomberg’s definition

Source: zeb/ value compass
TSR varies strongly across business models: International commercial banks and universal banks with low TSR performance since crisis

Business model and TSR performance – global Top 100 banks

### Business models of global Top 100 banks

- **Universal banks**
  - International
  - National

- **Commercial banks**
  - Mature markets
  - Growth markets

### TSR performance and vola before and after crisis


<table>
<thead>
<tr>
<th>Business Model</th>
<th>TSR ( p. \text{ a.} )</th>
<th>TSR-Vola ( p. \text{ a.} )</th>
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</thead>
<tbody>
<tr>
<td>National CB (growth markets)</td>
<td>44%</td>
<td>48%</td>
</tr>
<tr>
<td>National CB (mat. markets)</td>
<td>21%</td>
<td>13%</td>
</tr>
<tr>
<td>International CB</td>
<td>24%</td>
<td>12%</td>
</tr>
<tr>
<td>Universal banks</td>
<td>22%</td>
<td>19%</td>
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**Since crisis (2007–2011)**

<table>
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<tr>
<th>Business Model</th>
<th>TSR ( p. \text{ a.} )</th>
<th>TSR-Vola ( p. \text{ a.} )</th>
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</thead>
<tbody>
<tr>
<td>National CB (growth markets)</td>
<td>4%</td>
<td>47%</td>
</tr>
<tr>
<td>National CB (mat. markets)</td>
<td>0%</td>
<td>31%</td>
</tr>
<tr>
<td>International CB</td>
<td>-13%</td>
<td>39%</td>
</tr>
<tr>
<td>Universal banks</td>
<td>-16%</td>
<td>34%</td>
</tr>
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</table>

1) More than 30% of earnings from investment banking; 2) At least 70% of earnings from classic commercial banking; 3) Sum of capital gain and dividends relative to share price at beginning of period - Sample of 100 largest listed banks globally based on market capitalization in 2011; Source: zeb/research
RECAP: Financial crisis reveals four unsustainable business approaches in the financial industry

Main vulnerabilities of banks that failed

<table>
<thead>
<tr>
<th>Failing business approaches in the financial industry leading to the financial crisis¹</th>
<th>Lessons learned</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>High leverage</strong> &amp; aggressive short-term expansion of <strong>non-core business</strong></td>
<td>/ Focus on <strong>core competencies and sustainable value creation</strong></td>
</tr>
<tr>
<td><strong>Losses on trading activities</strong> and/or on investment portfolios</td>
<td>/ Impose <strong>stricter regulation²</strong> re/</td>
</tr>
<tr>
<td><strong>Poor lending decisions</strong>, incl. significant exposures to the property and construction sector</td>
<td>/ Funding/liquidity</td>
</tr>
<tr>
<td><strong>Overreliance on short-term wholesale funding</strong></td>
<td>/ Leverage</td>
</tr>
<tr>
<td><strong>Sachsen LB</strong></td>
<td>/ Capital requirements</td>
</tr>
<tr>
<td><strong>UBS</strong></td>
<td>/ Close the casino-like trading activities</td>
</tr>
<tr>
<td><strong>WestLB</strong></td>
<td>/ Enhance <strong>risk management</strong></td>
</tr>
<tr>
<td><strong>Bankia</strong> &amp; other <strong>cajas</strong></td>
<td>/ Reform <strong>corporate culture</strong> and <strong>compensation schemes</strong></td>
</tr>
<tr>
<td><strong>Hypo Real Estate</strong></td>
<td>/ Focus on <strong>real economy</strong> – limit proprietary trading</td>
</tr>
<tr>
<td><strong>Hypo Bank Alpe Adria</strong></td>
<td>/ Stop engaging in <strong>controversial business areas/practices</strong></td>
</tr>
</tbody>
</table>

1) See also e.g. Liikanen report  2) For details see Appendix 1
Many banks in search for new business models – sustainability as one of six megatrends to be considered

Megatrends relevance for business models

Regulatory pressure
- Pressure from regulatory authorities especially in terms of capital and liquidity requirements

Digitalization
- Massive impact on lives of people and hence, on the behaviour of clients, especially in retail banking

Internationalization
- Increasing migration flows across regions and growing importance of cross-border products and services transactions

Demography
- Ageing society increases demand for private pension products and services – replacement of public services

Sustainability
- Increasing awareness and demand for sustainable banking systems

Volatile world
- Higher volatility observed in several spheres – economy, environment, professional and private life

1) A megatrend is (1) valid for a period of minimum two decades, (2) observable in the relevant spheres of life, (3) an international phenomenon and (4) stable, able to survive setbacks
1. Current state of the banking industry and lessons learned from the crisis

2. Sustainability in banking – Fundamental change or just a tactical move?

3. The road ahead – Future sustainability in banking
In search for generating value, many banks are reshaping their business models towards more sustainable business practices – banks distinguish 2 dimensions

Financial and social-ecological sustainability

- Banks reshaping their business models / governance...

  **UBS**
  “UBS will unveil a split of its struggling investment bank next week [...] The move highlights how **banks around the world are trying to adapt to a radically changed regulatory and market environment** ...” Financial Times, 26.10.2012

  **RBS**
  “We’ve been working hard to change by **listening to our customers; engaging with the communities in which we operate; investing in our people; simplifying the services we offer; and pricing them in an appropriate and sustainable manner.**”
  Brian Hartzer CEO UK Retail RBS, 2011

  **SARASIN**
  “…globalization, demographic change, the shifting balance of power between the public, financial and corporate sector, and increasing environmental concerns. **All of these factors are radically challenging old business models and enforcing a new mindset for asset managers to embrace sustainable investment choices as a real opportunity.**” Global Private Banking Awards 2011 for Bank Sarasin

  **KFW**
  “**We protect the environment and climate** not only through the projects we cofinance in Germany and abroad, but also by pro-moting environmentally friendly conduct in our own operations” Dr Axel Nawrath, Member of Executive Board, 2011

  **GLOBAL PRIVATE BANKING AWARDS 2011**
  “I have been saying for a long time that **we cannot enter into a business transaction – however financially lucrative it may seem – if it puts our reputation at risk. Only company management focused on both performance and values can safeguard success over the long term.”
  Dr Josef Ackermann, CEO Deutsche Bank, 11/2011

- ... according to...

  **1**
  **Financial sustainability –**
  Solid financial performance with risks well under control

  **2**
  **Social/ ecological sustainability –**
  Fair treatment of environment, all members of society and all generations
Pre-Crisis paradigm that high RoE alone leads to high TSR rejected – empirical evidence shows that investors take more factors into account

RoE- vs TSR value creation model 2003-2011

Pre-crisis paradigm – RoE is the name of the game

2003 – 2011

Post-crisis paradigm – be balanced in all value dimensions

2003 – 2011

We have set a RoE target of 25%...

We need to set our targets considering a holistic set of metrics...

/ Banks focused mainly on RoE as financial performance indicator...

/ ... however, explanatory power of RoE on TSR is weak between 2003 and 2011 – banks with a RoE around 15% had a TSR between -66% and +75%

/ Broad set of metrics is needed to sustainably manage value creation (there is no magic number)

/ ...explanatory power can be increased significantly when considering value dimensions profitability, growth and constraints

Source: zeb/ value compass 2012
Strongly valued banks show above-average profitability, sustainable growth and fully comply with regulatory constraints

Drivers of value creation
Top 100 banks, 2003-2011¹

/ Investors focus on various characteristics when making their investment decisions – banks with a high (low) P/B ratio have similar characteristics.

/ Banks with top P/B ratios have on average high performance measures, high growth rates as well as capital and liquidity constraints well under control.

<table>
<thead>
<tr>
<th></th>
<th>P/B ranking</th>
<th>Performance</th>
<th>Growth</th>
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<tbody>
<tr>
<td></td>
<td></td>
<td>RoE</td>
<td>RoRWA</td>
</tr>
<tr>
<td>Top Quartile</td>
<td>2.95</td>
<td>23.7%</td>
<td>2.0%</td>
</tr>
<tr>
<td>2nd Quartile</td>
<td>1.97</td>
<td>19.8%</td>
<td>1.9%</td>
</tr>
<tr>
<td>3rd Quartile</td>
<td>1.48</td>
<td>15.7%</td>
<td>1.6%</td>
</tr>
<tr>
<td>Bottom Quartile</td>
<td>1.11</td>
<td>11.6%</td>
<td>1.3%</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th></th>
<th>P/B ranking</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>
<td>16.7x</td>
</tr>
<tr>
<td>2nd Quartile</td>
<td>1.97</td>
<td>10.5%</td>
<td>72%</td>
<td>17.0x</td>
</tr>
<tr>
<td>3rd Quartile</td>
<td>1.48</td>
<td>10.5%</td>
<td>66%</td>
<td>18.9x</td>
</tr>
<tr>
<td>Bottom Quartile</td>
<td>1.11</td>
<td>9.3%</td>
<td>58%</td>
<td>19.1x</td>
</tr>
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</table>

¹ Top 100 listed banks available on Bloomberg. 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.

Source: zeb/ value compass 2012
Summary: To create sustainable value five dimensions to be addressed

Success factors for top TSR performance

**Profitability**
- Solid performance still must-have
  - Efficient usage of capital (RoE) and assets (RoA)
  - Strong free cash-flow (adj. IBIT)

**Growth**
- Sustainable growth w/o violating profitability or constraints
  - Significant business in growth region (“The next 10”)
  - Market leader in terms of innovations (products/channels/etc.)

**Constraints**
- Zero tolerance re/ regulatory constraints
  - Capital: Reasonable capital base (EBA / Basel III definition)
  - Liquidity: Stable long- and short-term funding base

**Business Model**
- Transparency is key
  - Strong focus on classic banking, no opaque business
  - Well-known brands, long-established in the markets, etc.

**Corporate Culture**
- Compensation with more long-term focus
  - Link bonuses to long-term value creation
  - Reduce total bonus pools and extend retention periods

Source: zeb/ findings
8th ESDN Workshop
zeb/ has identified approx. 188 million people in Europe who seriously care about social/ ecological sustainability in banking

Social Banking in Europe

**Current demand for social banking**¹

- **The social-ecological**
  - 34.9 million (~4%)
  - Strong social and ecological awareness
  - Young segment, one out of three lives in large cities
  - Strict social and ecological criteria required for main bank

- **The sustainability-oriented**
  - 152.7 million (~19%)
  - Informed and educated elite
  - SR and sustainability awareness – invest in sustainable assets
  - A sustainable bank rather as a secondary bank or individual “green” products

- **The conventional**
  - 624.4 million (~77%)
  - Currently no target group for sustainable banking

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¹ Estimate calculated applying zeb/study results

Source: zeb/ research

121122 - Sustainability in Banking - 13
Range of possibilities to incorporate sustainability aspects into core bank business is wide – some concepts already applied successfully

Social banking in the German banking industry: Range of approaches

1) Corporate Social Responsibility
Source: zeb/research

Integration level of social banking characteristics in core business

1. CSR\(^1\) initiative

    - Taking and communicating corporate social responsibility

2. “Green” project savings

    - “Green” savings product or investment model for funding private/municipal/regional projects

3. “Green Affluent“ approach

    - Approach to target “Affluent“ clients: portfolio of socially responsible investments, sustainable wealth management programme

4. Sustainable product line

    - Introduction of a sustainable product line that is exclusively used to finance sustainable lending (or is invested in sustainable shares)

5. Spin-off bank brand

    - Spinning off of a social-ecological bank brand (e.g. via a branch)

6. Fully licensed bank

    - Establishment of a fully licensed bank with social-ecological orientation

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\(^1\) Corporate Social Responsibility
Investors, too, care more about Socially Responsible Investments – challenges for banks threefold

Importance and concept of Socially Responsible Investments (SRI)

SRI AuM have grown significantly over last decade – volume in Western Europe has roughly tripled since financial crisis to ~ 6.7 € trillion

Early empirical evidence suggested tendency for underperformance – recent research mostly finds similar or outperformance of SRIs

SRI is gaining in importance...

...however, there is no clear definition of SRI

“At this stage, no consensus on a unified definition of SRI exists within Europe, regardless of whether that definition focuses on the processes used, societal outcomes sought or the depth and quality of ESG (environmental, social and governance) analysis applied.” (Eurosif, European SRI Study 2012)

3 challenges for banks

Understand large variety of products, comparisons hardly possible – sustainability ratings as solution?

Cater to local investors’ demands and adhering to all regulations, standards and codes of conduct

“Qualify” as SRI by imposing strict guidelines/ governance and enforcing them across entire bank

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1) Compound annual growth rate; 2) Countries include Austria, Belgium, Denmark, Finland, France, Germany, Italy, Netherlands, Norway, Poland, Spain, Sweden, Switzerland, United Kingdom; 3) See Appendix 2 for a brief discussion

Source: Eurosif European SRI Survey, 2010 and 2012; zeb/ research
1. Current state of the banking industry and lessons learned from the crisis

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Before the financial crisis, banking and sustainability seemed to be incompatible...

Mismatch between banking industry and sustainability before the crisis

Before the crisis – two opposite worlds

(PARTS OF)
BANKING INDUSTRY

-/ Fulfilment of low regulatory requirements and lobbying for de-regulation
-/ Often simplistic view on value creation – maximization of RoE
-/ Utilization of high leverage to maximize short-term periodic profits
-/ Bonus culture contributing to excessive and imprudent risk taking
-/ Controversial business as long as it was not strictly illegal

SUSTAINABILITY

-/ Stronger regulation for a more stable financial system that serves society’s interests
-/ Sustainable value creation – holistic view on economic, environmental and social aspects
-/ Long-term focus considering liquidity/capital constraints and intergenerational equality
-/ Alignment of compensation schemes with long-term targets incl. clawbacks
-/ Governance for sustainable development - focus on real economy

“New normal” in banking industry
... in “new normal” strong momentum towards sustainable banking – however, overregulation to be avoided as strong banks vital for economic growth

Convergence of banking and sustainability

### New normal – Strong trend towards sustainable banking...

- **Full compliance with regulatory requirements** and cooperation with regulatory authorities
- **More holistic view on sustainable value creation** considering all value dimensions
- **Long-term business focus** – focus on real economy with very limited proprietary trading
- **Compensation/incentive schemes focusing on long-term performance** to avoid excessive risk-taking
- **Ban of controversial business practices** due to increasing pressure from investors, clients and society

### ... BUT keep in mind...

- **Making profits is not immoral** – investors must receive adequate compensation for providing risk capital
- **An efficient financial sector (incl. investment banking) is essential for a well-functioning economy**: it allocates capital and manages risks in an efficient way
- **Overregulation moves business to shadow banking (e.g. hedge funds)** – just shifting problems out of focus
- **There will always be a few “rotten apples”** who try to circumvent regulation

WILL THE BANKING INDUSTRY FURTHER RESHAPE BUSINESS MODELS TOWARDS MORE SUSTAINABLE BUSINESS PRACTICES OR IS EVEN MORE REGULATORY PRESSURE NEEDED?
Your contacts

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Appendix 1: Regulatory changes massively impact banks‘ business models – new rules of the game fundamentally change the industry

Regulatory changes - Excerpt

New capital and liquidity requirements with massive effects on product and service offerings

- Massive effects on products profitability and pricing – investment banking especially affected
- Limitation of maturity transformation due to liquidity requirements

Global recommendations for the segregation/penalization of universal and systemically important banks

- Separation of retail banking and limitation/ prohibition of proprietary trading
- Bank levy/ capital buffer for systematically important banks
- Further regulation in discussion

Limitation of cross-border transfer of capital and liquidity

- Restrictions from national authorities/ deposit guarantee funds regarding cross-border capital and liquidity flows
- At the same time discussions about EU-wide deposit guarantee fund

Different regulations with effects on value chain

- Broad range of regulations: From restrictions regarding OTC derivatives (EMIR) to limitations regarding cross-selling opportunities (client protection)
Appendix 2: Sustainability ratings could guide investors’ investment decisions – however no market standards available yet

Availability and development of sustainability ratings (SR)

Rating issuers can be grouped into

- **independent companies** (e.g. Sustainalytics),
- **research departments of banks**
- **firms** issuing other financial indices (e.g. Dow Jones, MSCI etc.)

### Actual rating issuers

Dow Jones Sustainability Indexes
In Collaboration With SAM

### Rating dimensions

- **Methods** (hard data, surveys…)
- **Focus area** (environment, society…)
- **Stakeholders** (employees, clients…)
- **Industry** (financial services, energy…)
- **Geography** (certain countries, global…)

- Development of ratings consider **different dimensions** – rating outcome depends on issuer and approach
- Investor need **transparency about applied dimensions and key aspects** – growing variety of rating approaches/ transparency levels
- **Global standards** (e.g. Global Initiative for Sustainability Ratings (GISR) to allow for comparability and foster convergence and harmonization of approaches