



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

8th ESDN Workshop

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1

Current state of the banking industry and lessons learned from the crisis

2

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

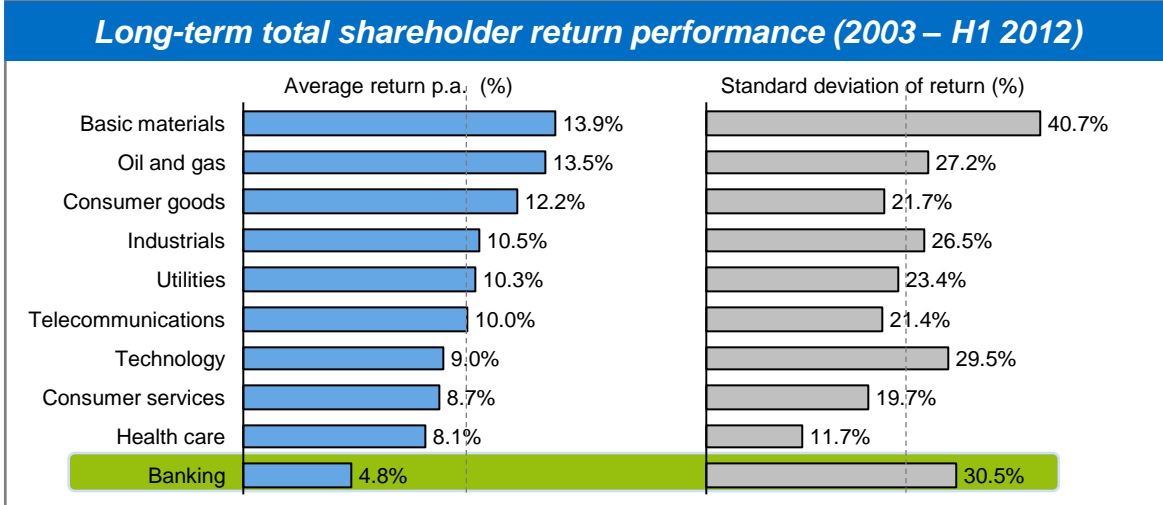
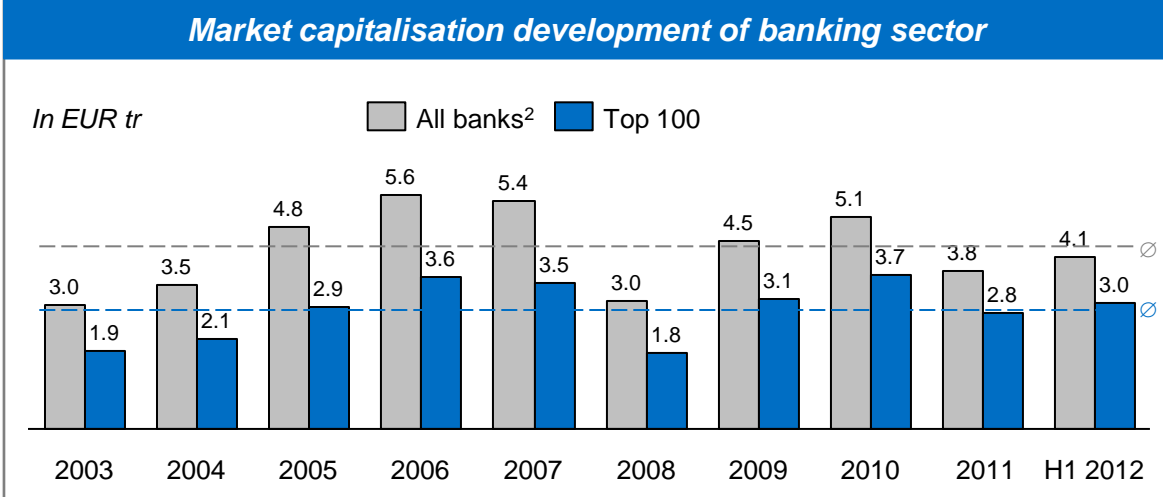
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The road ahead – Future sustainability in banking

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 sectors¹

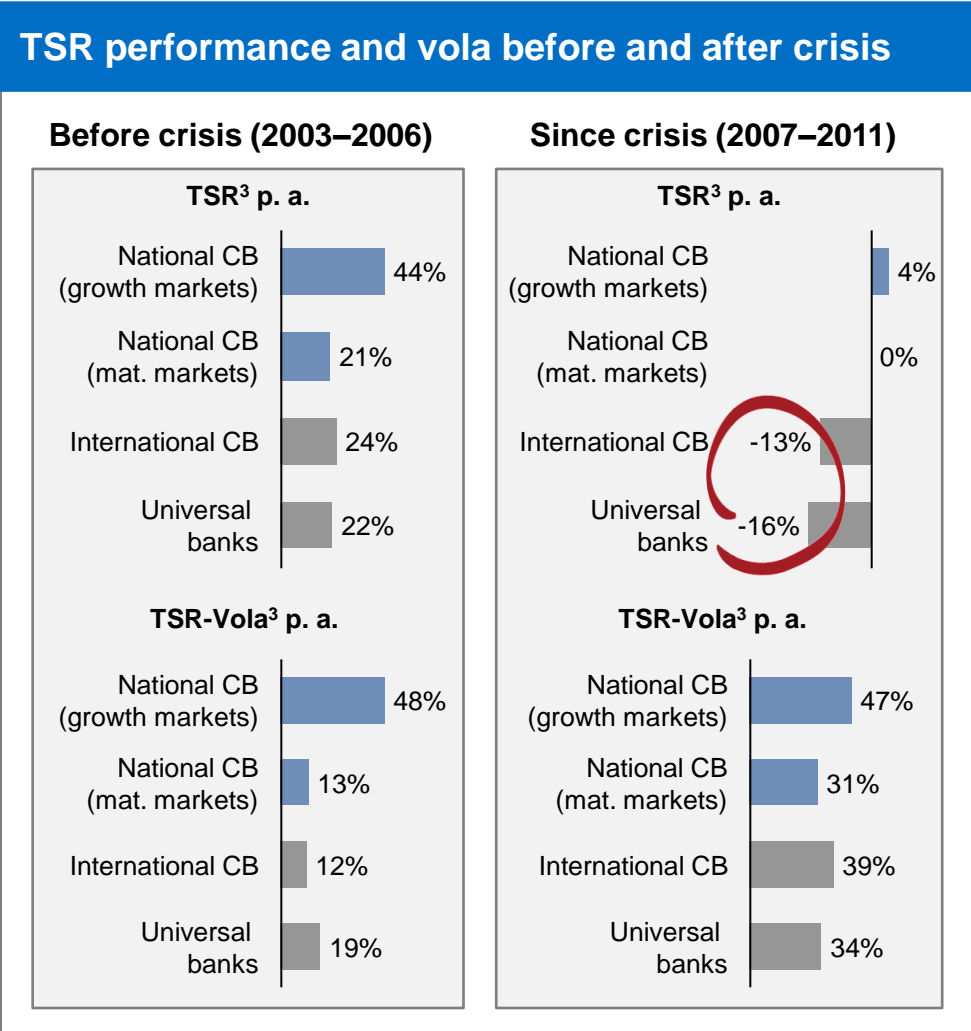
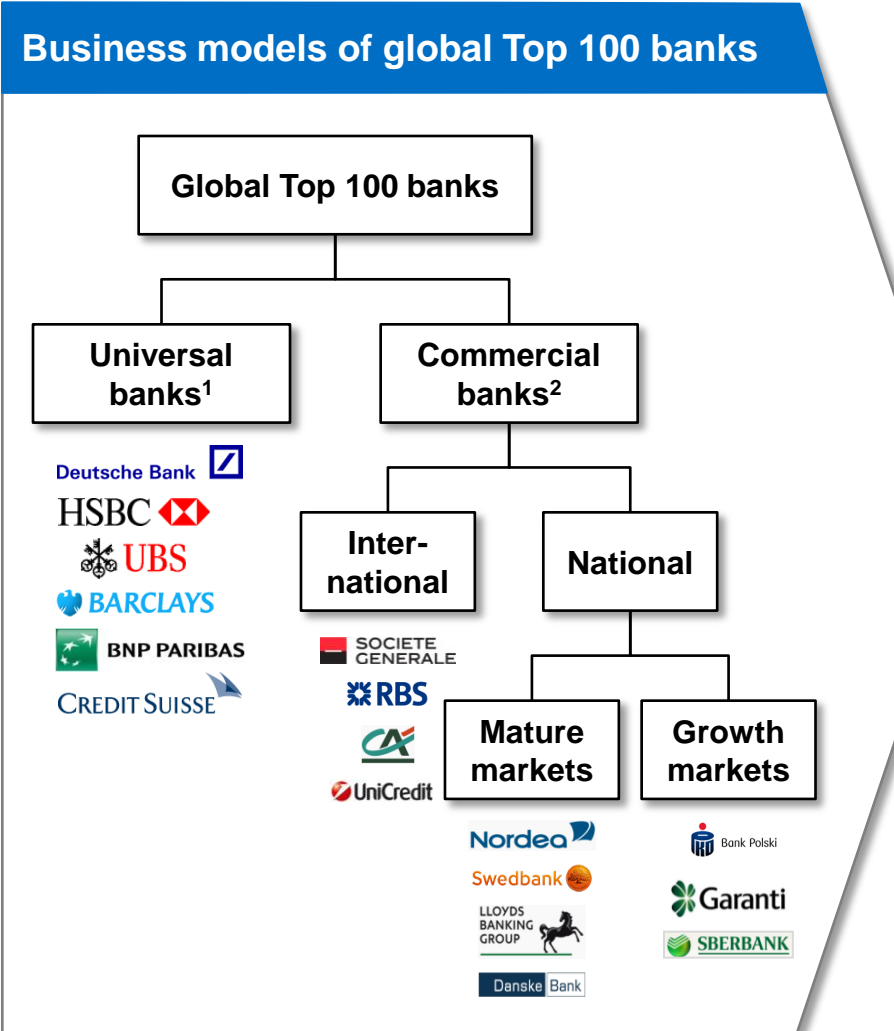
- / **Market capitalisation** of banking sector **increased from 2008 to 2010**, but a considerable part of the gain was lost in 2011 again
- / **Long-term performance rather weak** with an avg. p.a. return of ~4.8%. In fact, banking industry is significantly behind all other industries
- / While investors 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



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

Failing business approaches in the financial industry leading to the financial crisis¹

LEHMAN BROTHERS
RBS
Hypo Real Estate GROUP

High leverage & aggressive short-term expansion of non-core business

Sachsen LB
UBS
WestLB

Losses on **trading activities** and/or on investment portfolios

Bankia & other cajas
Hypo Real Estate GROUP
HYPOBANK ALPE ADRIA

Poor lending decisions, incl. significant exposures to the property and construction sector

DEXIA
COMMERCIAL CREDIT
northern rock

Overreliance on **short-term wholesale funding**

Lessons learned

- / Focus on **core competencies and sustainable value creation**
- / Impose **stricter regulation²** re/
 - Funding/liquidity
 - Leverage
 - Capital requirements
- / **Close the casino-like trading activities**
- / Enhance **risk management**
- / Reform **corporate culture and compensation schemes**
- / Focus on **real economy** – limit proprietary trading
- / Stop engaging in **controversial business areas/ practices**







1) See also e.g. Liikanen report

2) For details see Appendix 1

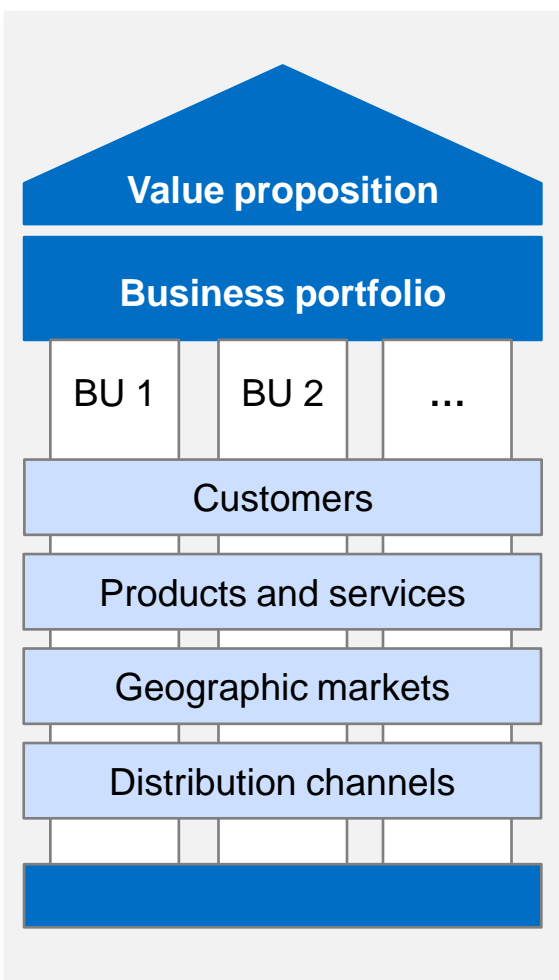
Many banks in search for new business models – sustainability as one of six megatrends to be considered

Megatrends relevance for business models

Megatrends¹...

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

... impacting business models



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 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



“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



“...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



“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

“**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



... according to...

1

Financial sustainability –
Solid financial performance with risks well under control

2

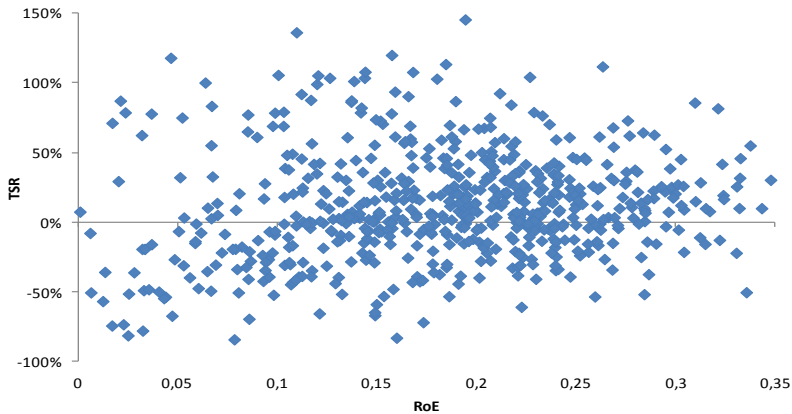
Social/ ecological sustainability –
Fair treatment of environment, all members of society and all generations

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

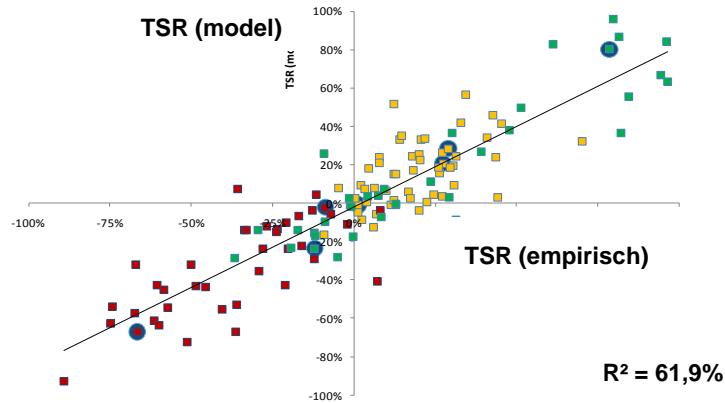


We have set a RoE target of 25%...

- / 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%

Post-crisis paradigm – be balanced in all value dimensions

2003 – 2011



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

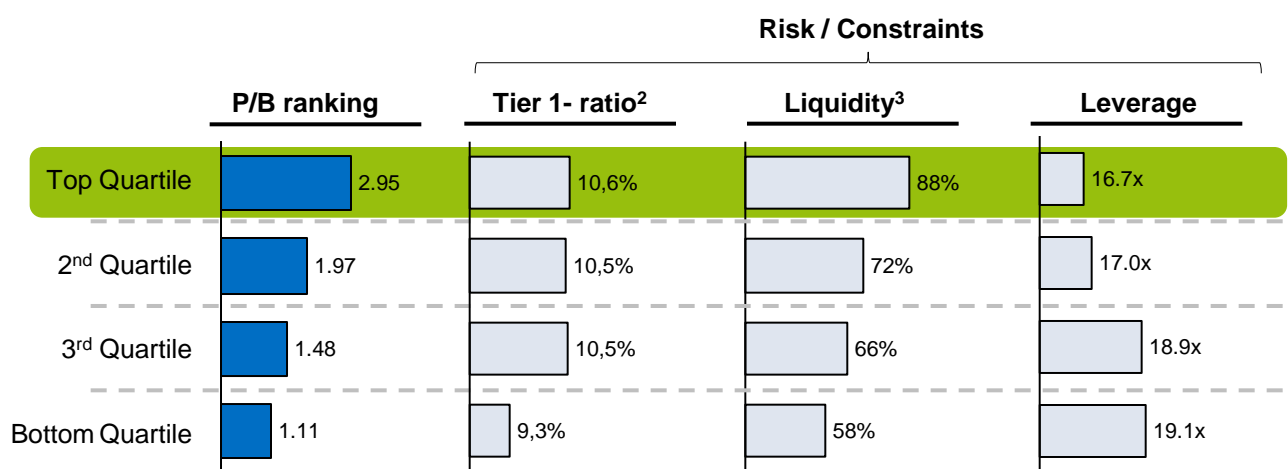
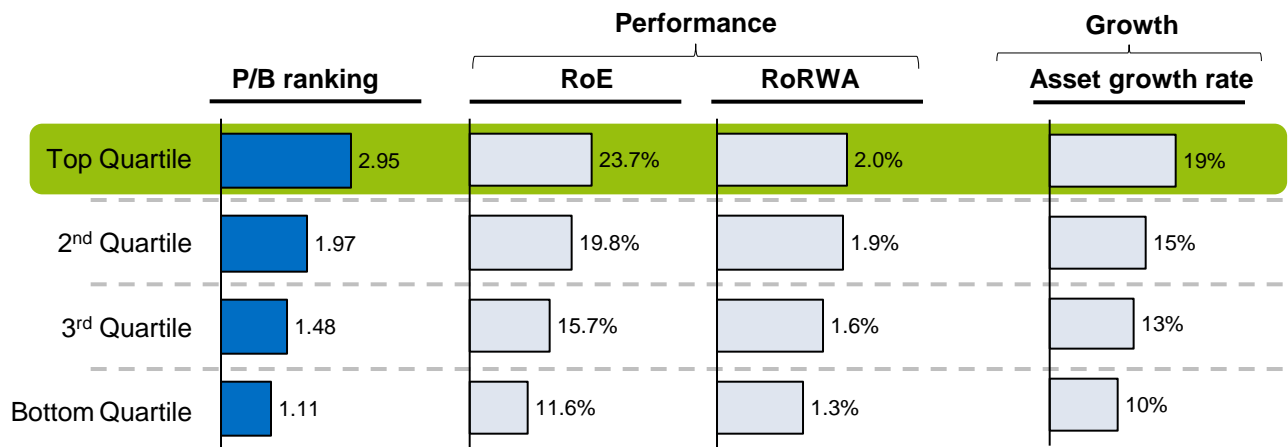
- / **Broad set of metrics** is needed to sustainably manage value creation (there is no magic number)
- / ...**explanatory power can be increased significantly** when considering value dimensions profitability, growth and constraints

Strongly valued banks show above-average profitability, sustainable growth and fully comply with regulatory constraints

Drivers of value creation
Top 100 banks, 2003-2011¹

[Backup](#)

- 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.



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. 2Tier 1-ratio represents proxy for Core Tier 1-ratio for which data is not available; 3Liquidity 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

Success factors for financial sustainability

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

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 banking¹

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

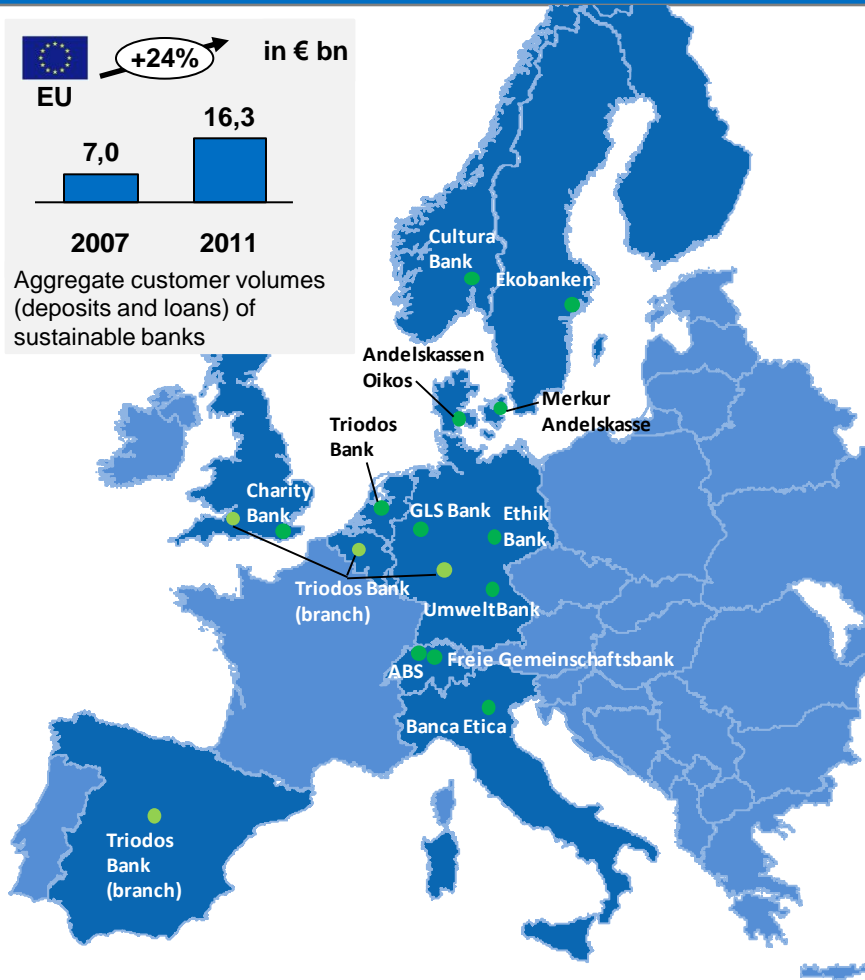
The sustainability-oriented

- / 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

Current supply by social banks

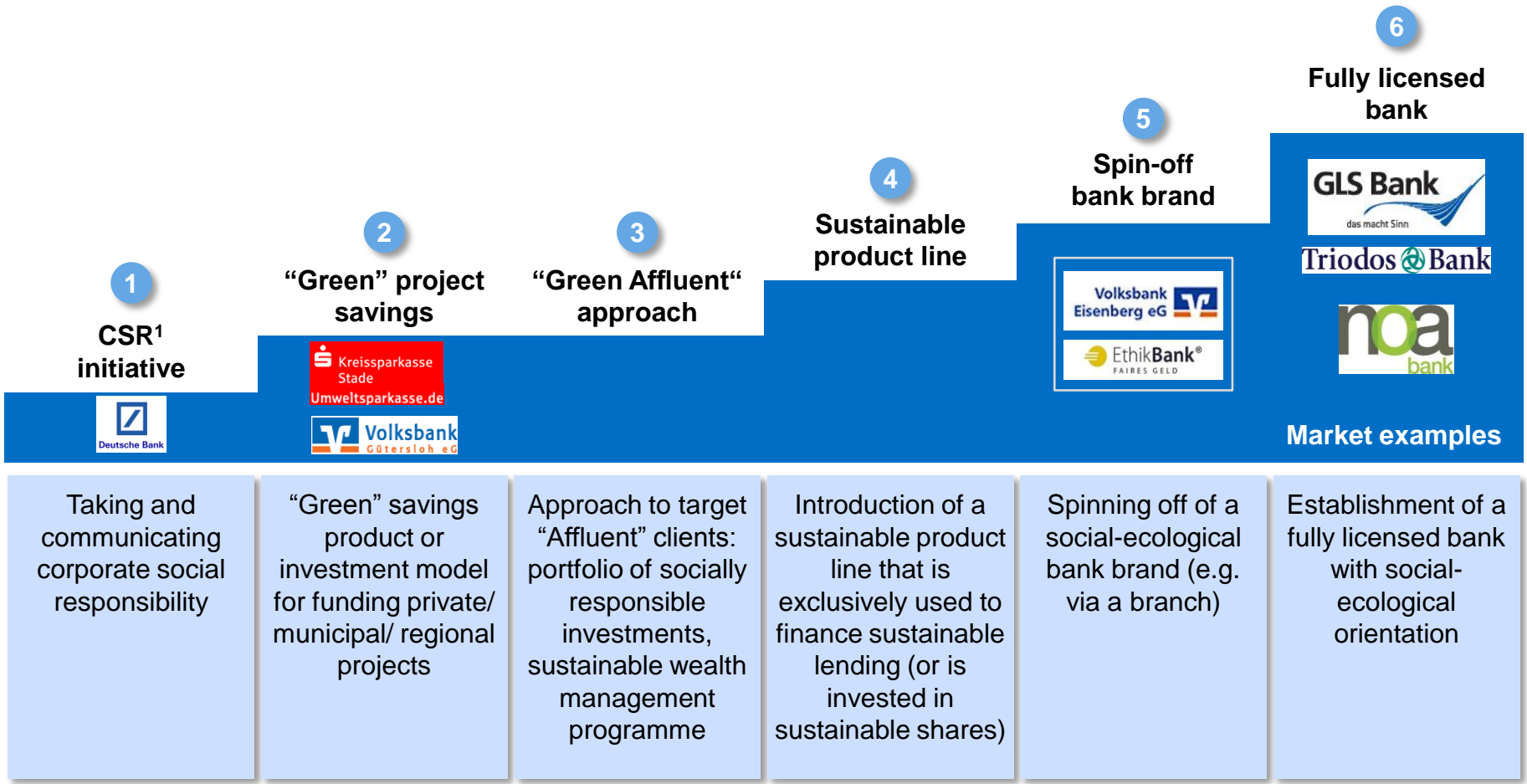


1) Estimate calculated applying zeb/study results

Source: zeb/ research

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



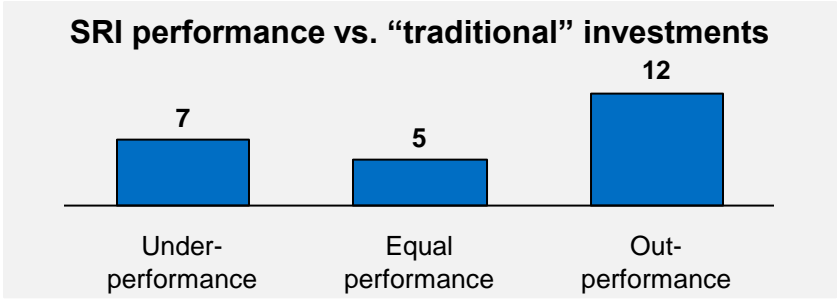
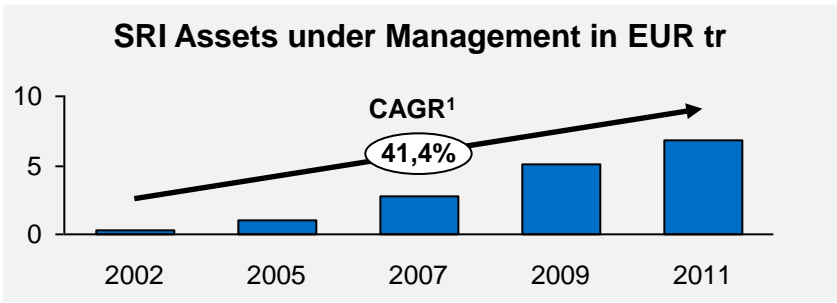
Integration level of social banking characteristics in core business

1) Corporate Social Responsibility
 Source: zeb/research
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Investors, too, care more about Socially Responsible Investments – challenges for banks threefold

Importance and concept of Socially Responsible Investments (SRI)

SRI is gaining in importance...



- ✓ **SRI AuM have grown significantly** over last decade – volume in Western Europe² 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**

...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

As investors	Understand large variety of products, comparisons hardly possible – sustainability ratings as solution? ³
As providers	Cater to local investors’ demands and adhering to all regulations, standards and codes of conduct
As asset/stock	“Qualify” as SRI by imposing strict guidelines/ governance and enforcing them across entire bank

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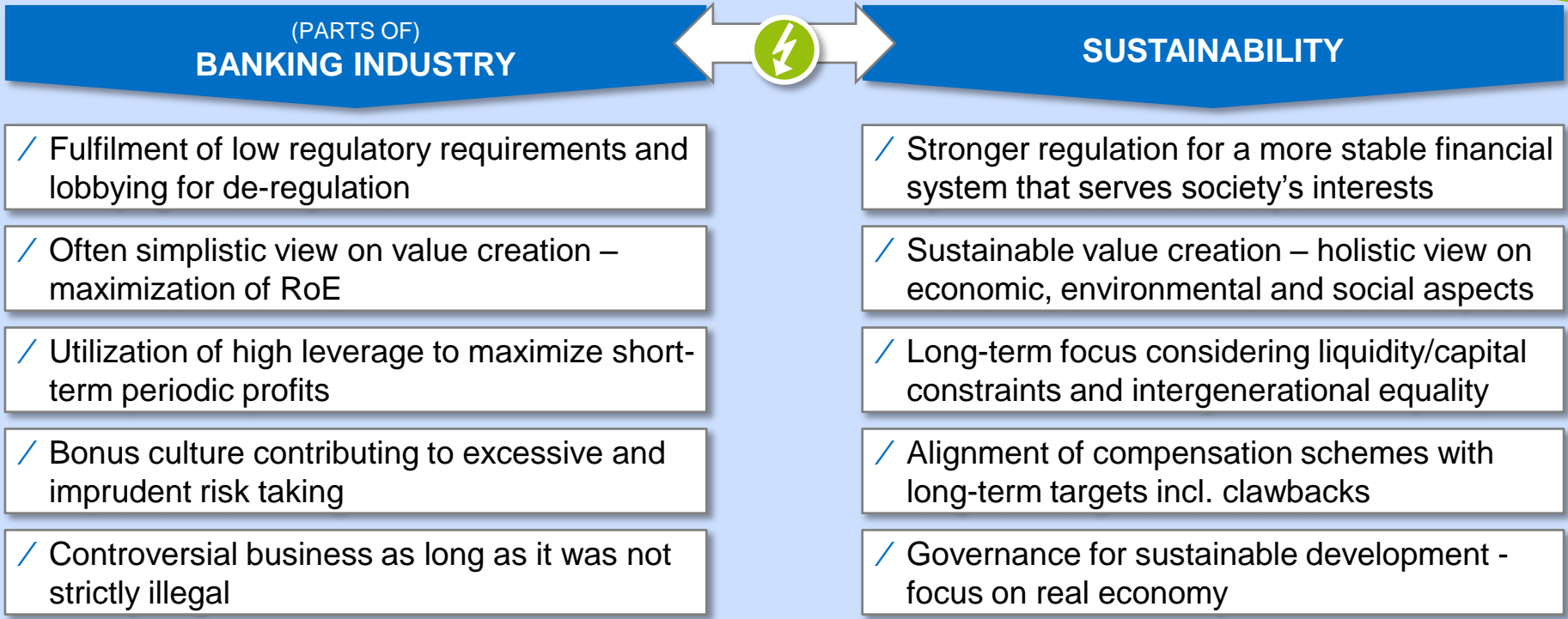
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Before the financial crisis, banking and sustainability seemed to be incompatible...

Mismatch between banking industry and sustainability before the crisis

SIMPLIFIED COMPARISON

Before the crisis – two opposite worlds



“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?



zeb/

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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




Solvency II

EBA

- / 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



Liikanen Report

Vickers Report

ICB Independent Commission on Banking
Final Report Recommendations

Dodd Frank Act

- / 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



BaFin


bankenverband

Entschädigungseinrichtung
deutscher Banken GmbH

Europäische Kommission

- / 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



EMIR

SEPA

MiFID

- / 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)

Actual rating issuers



Dow Jones Sustainability Indexes
In Collaboration With SAM

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.)

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