# Regulatory capital

> *Growing shareholder value in a changing world*

The results for the world's largest internationally active financial institutions – the G-SIBs – provide serious food for thought. A PwC study shows that in aggregate the G-SIBs destroyed shareholder value in 2014, by failing to generate returns in excess of their cost of equity (CoE). Only six of the 29 G-SIBs earned a positive Economic Spread (ES), being the difference between the return on equity and cost of equity. As a group the G-SIBs delivered a negative economic spread of -2.9% (refer figure 1).

By comparison the four Australian major banks, in aggregate earned an economic spread of 5.3%, placing them in the top quartile of the G-SIBs, ahead of all but four individual G-SIBs.

Within the G-SIBs group there are significant regional variations. European and US banks have faced material re-structuring and remediation costs, as well as continued weak underlying profitability, dragging down the global total. By contrast the six Asian G-SIBs returned a combined ES of 5.2%, illustrating the overall strength of the region.

The performance issues in European and US banks do not explain the whole story. The variability in ES is also attributable to differences in CoE between business segments, a function of business mix and leverage.

Looking ahead, a deeper understanding of these dynamics could provide Australian banks with the insight required to meet future shareholder expectations.

With a reform agenda including Basel IV and the Financial System Inquiry (FSI), the biggest topic in town seemingly is bank capital. The universal view is that regulatory capital requirements will increase – possibly substantially, putting pressure on return on equity (RoE) and prompting banks to scrutinise allocation of their scarce capital resources. Allocating capital based exclusively on RoE may not be the answer to maximising shareholder value. Economic spread analysis has an important role to play.

Our starting proposition is that ES provides a better guide to shareholder value creation than headline RoE. ES captures variation in the cost of equity between institutions and business lines, factoring in shareholders' assessment of risks, such as leverage and earnings volatility.

Our preference for ES is backed up by market data which shows a stronger correlation between ES and the share price performance than ROE.

The real value of ES lies in its ability to capture changing market expectations at a business segment level and use the information to drive strategic portfolio decision-making.

Our study of the G-SIBs business segments revealed some real gems (refer figure 2). We found that:

- cost of equity varies substantially between business segments, with retail banking towards the upper end of the range
- corporate banking has a substantially lower cost of equity than both retail banking and asset management
- on an aggregate basis, retail banking has generated a negative economic spread.

To summarise Economic Spread is a more insightful indicator of shareholder value creation than RoE alone and is very relevant at the business segment level, because cost of equity varies by segment.

However, a note of caution is warranted. CoE estimates are always inferred and so are subject to the usual limitations of economic assumptions. Moreover, in real-world stress events the cost of equity can change rapidly.

We see great value in applying an ES driven approach. It provides an additional lens through which to inform capital allocation decisions and also challenges some conventional wisdom around the impact of increased regulatory capital.

## Increased regulatory capital may not always be bad for shareholder returns

Conceptually reducing leverage lowers the cost of equity and so increased regulatory capital may not *by itself* be all bad for shareholder value creation. To impact shareholder value creation, there has to be a real change in the underlying risk-reward equation. One such change could be the regulators' rationale for more capital, which is to wind back implicit taxpayer subsidies to equity holders.

**Figure 1: Banking sector performance summary**

| Business segment | Leverage times | ROE % | CoE % | ES % |
|---|---|---|---|---|
| G-SIBs | 13.5 | 8.4% | 11.3% | -2.9% |
| Asian G-SIBs | 15.7 | 15.1% | 10.0% | 5.2% |
| Australian Majors | 16.0 | 15.9% | 10.6% | 5.3% |

> ❝ ***Regulatory capital changes will not make business lines uneconomic – but they do demand a shareholder-value driven response***

## RoE driven responses risk destroying shareholder value

Regulatory capital increases rarely make once good businesses bad. Increased capital requirements dilute RoEs, but also reduce CoE. Typical responses to increased regulatory Capital involve cutting back – or even selling businesses which don't meet existing RoE hurdles. However, these businesses may be contributing superior ES compared to other segments when business segment specific CoE is used instead of banks' overall CoE.

## Regulatory capital is a short term supply constraint, and should be managed as such

Although capital may be constrained in the short run, ultimately for the right investments, it can be raised to meet regulatory requirements.

As such, efforts to optimise risk weighted assets (RWAs) are a response to a supply issue, not a way to maximise value.

It is worth remembering that there are more fundamental issues to consider in terms of setting strategy than trying to engineer efficiencies in regulatory capital requirements. Issues such as digital which are transforming everything from customer offerings to operating platforms, while introducing new sources of competition.

Yet another reason that having a measure that effectively cuts through some of the noise and distortion caused by changes in regulation, enabling a coherent and consistent view of economic performance under different commercial scenarios and business settings is more important than ever.

ES, as a performance measurement framework, is grounded in analysis of shareholder value and required returns. It cuts through the maelstrom of change – whether regulatory, technology or economic – and provides a valuable lens through which to make portfolio shaping decisions in a changing world.

**Figure 2: Segment performance**

| Business segment | Leverage times | ROE % | CoE % | ES % |
|---|---:|---:|---:|---:|
| Asset management | 1.13 | 12.1% | 11.0% | 1.1% |
| Investment banking – Advisory and origination | 0.80 | 12.1% | 11.4% | 0.7% |
| Corporate banking | 10.37 | 7.4% | 8.0% | -0.7% |
| Private banking | 12.50 | 8.1% | 10.1% | -2.0% |
| Retail banking | 16.33 | 10.1% | 13.9% | -3.8% |
| Investment banking – Global markets | 18.62 | 4.1% | 11.6% | -7.5% |

**Contact us**

**Julie Coates**, Partner
Banking and Capital Markets Leader
+61 (2) 8266 2006
julie.coates@au.pwc.com

**Ashley Rockman,** Partner
Financial Risk
+61 (2) 8266 1882
ashley.b.rockman@au.pwc.com

**Colin Heath**, Partner
Financial Services
+61 (3) 8603 0137
colin.heath@au.pwc.com

**Jason Slade**, Partner
Financial Services Consulting Leader
+61 (3) 8603 4803
jason.slade@au.pwc.com