

# Balance sheet optimisation: the returns dilemma for banks



Ever since the financial crisis, there's been a gap between the returns banks are required to deliver by investors and the returns they have actually been able to achieve. The underlying causes are largely structural rather than institutional. Yet the issue is so problematic that the average return on equity for large European banks is five percent compared with their long-run cost of capital of ten to twelve percent, according to KPMG research<sup>(1)</sup>. And that gulf shows no sign of narrowing.

Low or negative rates have exacerbated the problem by depressing margins. Costs have risen thanks to a swathe of post-crisis regulatory change. Basel III, the international framework designed to improve the regulation, supervision and risk management within the banking sector, requires banks to bolster capital ratios. While the resulting increase in capital levels has indeed made banks safer, it has also diluted returns: investor returns have not been re-priced to take into account of the reduced risk. In other words, banks face the worst of both worlds: income opportunities are reducing, while investor expectations (on a risk-adjusted basis) are rising.

This gap between returns on capital and the cost of that capital cannot continue indefinitely. The key question is: how can banks reduce the disparity?

## How do you optimise the balance sheet in a world of regulatory change?

In many ways, the regulatory landscape is moving in a direction that hampers banks' efforts to improve returns on capital – although that doesn't mean it's impossible. The traditional means by which banks have typically driven capital efficiencies are two-fold: firstly, by centralisation of risk in one entity to allow netting and diversification; secondly, by ensuring that this entity has extensive internal model permissions. In our view, this approach runs counter to two key themes shaping the regulatory landscape.

### Increased focus on legal entity integrity:

The former Governor of the Bank of England, Mervyn King, observed that the financial crisis showed that banks are 'global in life and national in death'. The realisation that legal entities still matter when a business fails has driven a clear regulatory focus on the integrity of those legal entities and ensuring that they have sufficient capital and liquidity in each entity within the group. This can be seen clearly in the ring-fencing requirements in the UK and in the Intermediate Holding Company requirements in the US.

### Scepticism of internal models:

The crisis has resulted in widespread mistrust of internal models amongst stakeholders. The lack of consistency, suspicion of 'gaming' and potential for underestimation of risk has ushered in a regulatory retreat from internal models. The leverage ratio, in particular, has dramatically reduced the utility of models in driving reduction in capital. If implemented, the Basel IV package, with its focus on floors based on the standardised approach, will reduce the scope and capital efficacy of models further.

Given this background, banks pursuing traditional mechanisms for balance sheet optimisation run the risk of holding back the tide in vain. A different approach is needed – one that goes with the flow of regulatory change.

### Four ways to split the initiative

In the new regulatory environment, four principles underpin the successful optimisation of the balance sheet:



#### Efficient use of local balance sheets:

Trapped capital is an increasingly common problem across the industry, as banks face a number of sub-scale legal entities with no clear purpose or way to repatriate pools of capital. Banks need to be more rigorous in defining the purpose of these balance sheets and finding a way to migrate relevant business to them.



**Focus on the product set:** The time when banks could afford to offer 'all things to all people' has long gone. In a world where capital is scarce, there must be a focus on products that genuinely generate returns.

Banks also need to explain how cross-subsidies between products actually work in practice. This calls for a clear and consistent basis for measuring returns, made more difficult by the interaction between leverage and risk-weighted assets. Despite those difficulties, ensuring there is discipline around which products are offered, the purpose they perform and the returns they generate is vital to ensuring optimal allocation of capital.

Note: (1) <https://assets.kpmg.com/content/dam/kpmg/xx/pdf/2016/10/the-profitability-of-eu-banks.pdf>.



**Active liability management:** Balance sheet optimisation has traditionally been an asset-driven exercise, as banks attempt to reduce Risk Weighted Assets (RWAs) or increase return on assets. This approach, however, is looking increasingly obsolete. Instead, the leverage ratio and Net Stable Funding Ratio (NSFR) makes it essential to have a liability side strategy to complement optimisation of assets. Excess deposits that cannot be used in a way that brings in consistent returns, swell the balance sheet and increase capital pressures. The potential impact of the Payment Services Directive (PSD2) and Open Banking on the velocity of deposits will only increase the value of better liability management.



**Dynamic re-allocation of capital:** Given the current scarcity of capital and its cost relative to returns, banks need to have a mechanism to re-allocate across business lines, or within a business line, to ensure it is deployed in the most efficient way. In a rapidly changing market and regulatory environment, the velocity of capital re-deployment is just as important as where capital should be allocated initially. Bank wide, this re-assessment still occurs on a primarily annual basis.

The challenge, then, is how to put these principles into practice. Balance sheet optimisation projects typically face one of two problems. Firstly, they may identify one-off changes that relieve short-term pressures but fail to solve long-term sustainability. Or secondly, they identify longer-term strategic changes that yield longer-term benefits but are not executed thanks to high short-term implementation costs and minimal short-term pay-off.

The appeal of the above principles is they can be achieved by banks changing and improving their internal processes, rather than one-off projects. If banks can design a balance sheet management framework that encourages, facilitates and rewards the front line businesses for engaging in efficient behaviours, it will achieve increasingly optimal deployment of financial resources through time. What would this look like?

## Four steps to success

### 1. Mobilise a team

Banks need to ensure effective collaboration, whether this is through the formation of a specific balance sheet management unit or through assembling a cross-functional 'task force'.

### 2. Define clear objectives

The balance sheet management framework needs to be designed to achieve clearly stated and commonly understood objectives beyond mere satisfaction of regulatory ratios.

### Solving the dilemma: designing a balance sheet management framework to achieve optimisation

Increasingly, we see that banks are forming a balance sheet management unit, combining treasury, risk and finance personnel with a mandate for optimising balance sheet usage. Working with the business, a team can identify short-term tactical measures to improve efficiency as well as longer-term opportunities.

These changes should not only be focused on improving efficiency or accuracy but also on changing outcomes. To this end, it should include consideration of more drastic or imaginative ideas. For instance, to ensure dynamic re-allocation of across business lines, the treasury could create an 'internal market' for capital. In other words, businesses with surplus capital could 'sell' back to the treasury, which in turn could be re-allocated to businesses with more growth opportunities. In a similar way, to achieve re-allocation of business across balance sheets, firms could find ways to offer differentiated pricing across legal entities, so that clients and the front office are incentivised to book business to the legal entity where there is a surplus.

### Closing the gap

In responding to the returns dilemma, banks face a choice: pursue as best they can the practices of the past or re-define balance sheet management in light of future regulatory change. In our view, success for banks clearly lies in taking the latter approach.

While re-designing the balance sheet management framework might help improve returns, there are also a raft of structural solutions—the sale of non-performing loans and the sale of portfolios or entities—which will be vital for resolving the problem in future. But, unless banks re-design their framework for managing their balance sheets, the gains derived from these structural solutions may be lost.

By keeping these principles in mind, banks should be able to close the gap between what investors demand and what they themselves can deliver.

## Contacts

### Peter Rothwell

[peter.rothwell@kpmg.co.uk](mailto:peter.rothwell@kpmg.co.uk)  
+44 20 7694 2421

### Dan Bolland

[dan.bolland@kpmg.co.uk](mailto:dan.bolland@kpmg.co.uk)  
+44 7795 366933

### Nicholas Mead

[nicholas.mead@kpmg.co.uk](mailto:nicholas.mead@kpmg.co.uk)  
+44 20 7694 4532

### Steven Hall

[steven.hall@kpmg.co.uk](mailto:steven.hall@kpmg.co.uk)  
+44 20 7311 5883

### 3. Identify and execute 'quick wins'

Once the objectives have been clearly defined, banks should identify actions that can deliver tangible short-term results.

### 4. Reform the framework

Over the longer term, banks should look to reform their balance sheet management framework, including planning & forecasting, data, reporting and transfer pricing.