Repositioning along the capital efficient frontier

Karen Rollin of A.T. Kearney charts the rise in risk management from merely a control mechanism to a strategic tool.

Risk management is playing a new role in the financial services industry. What was once merely a control mechanism concerned with the identification, measurement and pricing of risk, is now a strategic tool for enhancing the business portfolio to meet shareholder expectations of growth and earnings quality.

Growth and earnings quality

The pace and scale of consolidation in the financial services industry has already created an appetite in investors for super-charged revenue growth. For financial services players to maintain their current market position over the next five years, financial institutions are expected to have to double today's revenue growth rates, from 10–15% to 20–25% per annum. As a result, all financial service players are under intense shareholder pressure to make their capital perform more effectively.

But earnings growth alone is not enough. Investors are also looking for high earnings quality, regarding it as a key indicator of financial health. Companies that are able to generate quality earnings are rewarded. Earnings quality is a function of two components: earnings size and earnings volatility. The latter, represented by earning surprises or profit warnings are usually representative of risks which are not being managed, resulting in the earnings stream being volatile. Such volatility can have an enormous impact on market capitalisation, through lower investor confidence. As *Figure 1* shows, the size of the loss is usually a fraction of the decline in market capitalisation.

Given these twin demands – high growth and earnings quality – financial services players are having to reposition their business portfolios. They need to be able to select and build a product portfolio with profitable, growing segments as well as good quality earnings. But how should they respond to this challenge?

The business portfolio

Financial services players require a process for reliably comparing businesses so resources can be allocated to areas that produce accelerated quality earnings growth. For any financial services firm bent on repositioning its portfolio, there are two overriding issues:

- **selection and concentration** – where are the star performers? What areas present divestiture possibilities? Who are – and should be – the core customers?; and
- **business portfolio optimisation** – is there a business mix that optimises the institution's return, given the risk profiles of the underlying businesses? What effect do the selection/concentration decisions have on the institution as a whole?

Recent developments now mean that there are new processes and additional tools with which to approach these issues.

Selection and concentration

Since the 1970s companies have used a number of business portfolio evaluation tools. While the dimensions differ, all assess the market in some way and suggest areas in which to grow or divest. However, increasingly sophisticated investors and intense competition means that these market measures have to be supplemented by measures that address earnings quality and facilitate peer, as well as internal, comparisons.

Karen Rollin

Analysts and institutional investors pay close attention to earnings quality because they perceive high earnings volatility as a symptom of poor risk management. Earnings volatility expresses all types of risk that affect a company's bottom line – from market risk as a result of fluctuations in the revenue stream, to credit risk from changes in credit provisioning and write-offs (which typically account for about 70% of the overall volatility), through to operational risks from charges and costs which impact the bottom line.

One measure applied by A.T. Kearney, is the earnings risk cover (ERC^{sm}). This is an earnings quality index, similar in design to dividend cover, which measures how many times an entity's earnings cover any volatility in those earnings. ERC is a function of two elements: earnings size and underlying volatility. Hence, a high ERC demonstrates an ample risk cushion, whereas a low ERC indicates that earnings will not adequately cover any significant fluctuation.

Figure 2 presents the ERC for a select group of financial institutions. Investment banks have often received a bad deal in terms of market misperceptions of earnings volatility. Market volatility, however, does not necessarily translate to earnings volatility. This is evidenced by players such as Chase which has outperformed many domestic commercial banking institutions. Similarly, geographic dispersion in players such as HSBC has dampened the high market volatility of Asian and Latin

FIGURE 1

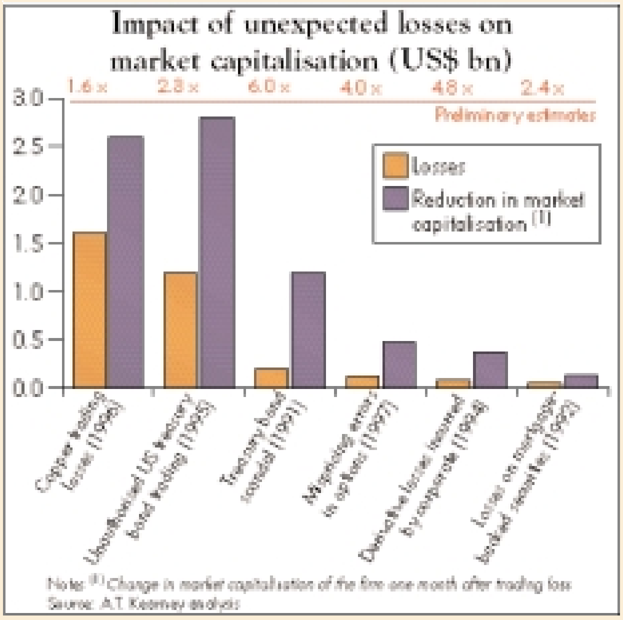
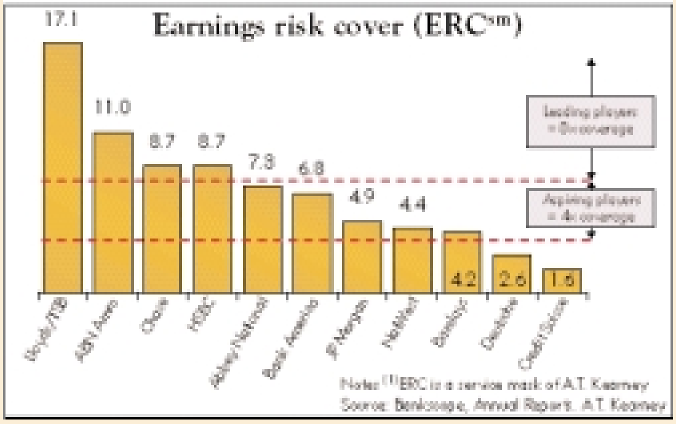


FIGURE 2



American markets, enabling them to maintain high earnings quality and strong ROEs, which are reflective of their underlying business portfolio.

On a more detailed level, institutions should understand how individual businesses and product lines contribute to corporate volatility. Management is often surprised when the investment banking business has a healthy ERC, while retail businesses are below average. The question for senior management is the scale effect of these businesses on the corporate group.

Financial service players require a process for reliably comparing businesses so that resources can be allocated to areas that produce accelerated quality earnings growth. Most importantly, decisionmakers should compare business units against their peers outside the firm. That is, a business unit's contribution should be measured against the performance of the top quartile, or similar industry grouping, rather than against an internal enterprise-wide hurdle rate. Most institutions are conglomerates with diverse business activities, so a corporate ROE benchmark is fairly meaningless.

Divisional reporting that separates, for example, investment banking from commercial banking activities, helps to some extent. However, such analyses have traditionally compared return on equity, revenue or earnings growth, and efficiency measures within the group. These comparisons fail to incorporate the particular profiles of the underlying businesses, such as the propensity to grow or inherent risk characteristics. For instance, venture-capital businesses can attract 40+% growth, but they are highly volatile and susceptible to downturn.

One leading player has taken such comparisons to their logical conclusion. In spite of its asset management business achieving a ROE of 21%, well in excess of its 16% corporate hurdle rate, it replaced the head of the business because the average ROE for the industry was in excess of 26%. Against this benchmark, the bank's asset management division had underperformed the market and therefore destroyed value.

Business portfolio optimisation

Having determined the earnings quality for each business, both in-house and against peers, the next step is to evaluate the relationships that exist between them. Parallels can be drawn with the Markowitz theory that stated a certain set of portfolios of stock, maximise return for a given risk. Similarly, by changing the concentration of businesses making up the group portfolio, there are a discrete set of portfolios which maximise return for a given risk. This set of portfolios is called the capital efficient frontier (CEF). It involves evaluating the relationship and synergies between the businesses.

Too often institutions review the businesses comprising the portfolio on a stand-alone basis, without considering the performance of the whole group. Due to the interactive effects of return and risk, aggregating a bank's retail and corporate businesses, for example, at current proportions of 70% retail and 30% corporate, may not produce the optimal return-risk result. Alignment to the efficient frontier requires an understanding of the trade-offs and effects of a changing business mix on the performance of the whole group, given the constraints in terms of business expansion and divestment and senior management's risk appetite will mean some efficient portfolios are off-limits.

The efficient portfolio concept has many advantages over traditional business portfolio analyses:

- **inter-relationship (revenue dependency)** – incorporates the interrelationship between businesses in various economic conditions, in addition to enforcing traditional performance metrics;
- **sensitivity analysis** – as investors increasingly value stability in earnings, an important task of management is to optimise the earnings–risk trade-off. CEF facilitates this by modelling the impact of a change in the business mix, the underlying business performance and constraints on the group as a whole in a multitude of different scenarios; and
- **analytical direction** – traditional business portfolio analysis yields general strategies of expand, maintain or exit, but can leave management at a loss as to what level of expansion is needed. The CEF yields specific capital allocation profiles.

Before embarking on performance improvement projects on a business-line basis, management should question whether group performance can be improved by reconsidering the current business mix.

FIGURE 3

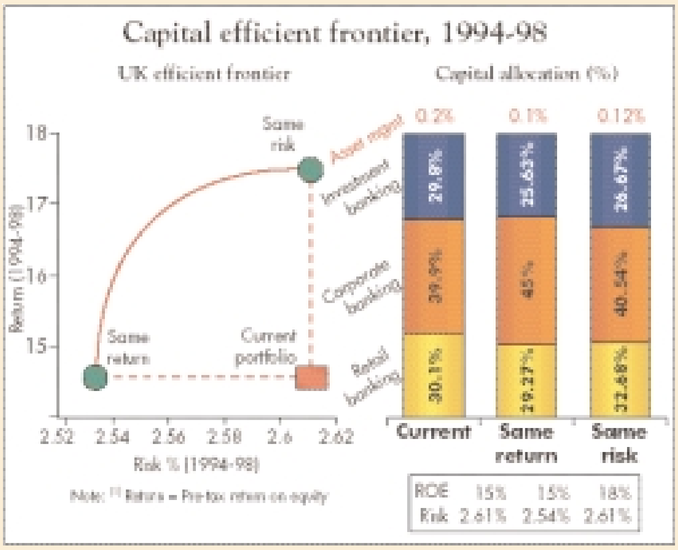


Figure 3 illustrates a case example of a portfolio that provides an ROE of 15%. The curved arc represents the selection of portfolios where risk is minimised and return maximised, that is the CEF. Here, it is possible to maintain current group performance and lower the overall risk by re-allocating capital among existing businesses (as in the 'same return' portfolio) or maintain the current risk profile and increase the return on capital (as indicated by the 'same risk' portfolio).

The bar charts in *Figure 3* illustrate the differing proportions of capital allocated to retail banking, corporate banking, investment banking, and asset management for these three portfolios. For the two efficient portfolios same return and same risk, the results suggest decreasing business written by asset management and investment banking activities, while at the same time increasing the underlying corporate banking business.

Valuable insights can be derived by adjusting the return-risk profiles of individual businesses. For example, we can explore the effects of cost reductions and growth targets not only on each business, but on the group performance and shape of the efficient frontier.

While efficient portfolio analysis yields specific capital allocation profiles, it should be supplemented by other tools and executive judgement for strategic decisions. For example, business dependencies and franchise values may restrict divestiture or downsizing. The practicality of achieving certain returns depends on the group's risk tolerance and management's strategic vision. Competitive positioning will provide important extra input to the decisions.

Sharp changes in financial services require financial institutions to consider future positioning and prospects. Risk management is no longer restricted to pricing and control, but has a key part to play in shaping the business portfolio. Institutions must make considered, informed choices about pursuing quality earnings growth to reposition along the capital efficient frontier.

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