STRATEGIC FINANCIAL RESOURCE MANAGEMENT
BANK STRATEGY IN THE NEW WORLD

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EXECUTIVE SUMMARY

As a bank CEO or senior executive, you need to evaluate and decide on important shifts in strategic direction, such as adding a product line, growing your assets with certain client segments, or pulling back from some geographies. Rather than wondering whether these shifts will meet your objectives, wouldn’t you prefer to have a fairly good idea, within a few hours, of what those moves might mean for your returns and all those complex financial constraints and ratios that regulators have imposed? This may seem like a pie-in-the-sky idea, but leading banks are starting to achieve it, using a framework we call Strategic Financial Resource Management (SFRM).

Why can’t most banks do this today? Managing returns on equity with constrained financial resources has become exponentially more challenging for the CEOs and CFOs of large financial institutions since the global financial crisis of 2008-2009. That disaster spurred a major expansion of regulatory requirements and new, more complex, and tighter financial resource constraints. (While there has been much talk recently of deregulation or a loosening of some of these constraints and standards, we believe the regulatory regime for banks will remain highly complex with a multitude of requirements interacting with each other.)

These capital, liquidity, leverage, funding, and other requirements and constraints on the bank include CET1, LCR, SLR, GSIB, TLAC, NSFR and many other acronyms with complicated formulas that differ by institution and jurisdiction. The impact of this new alphabet soup of constraints on different products, businesses, and jurisdictions – and the non-linear relationships and trade-offs between them – is not easily determined, let alone fully understood.

Furthermore, while many globally systemically important banks (GSIBs) have made recent progress on implementing these measures, most banks still do not have well-calibrated methodologies to charge for usage of financial resources like capital, liquidity, and funding that are sufficiently well-understood by and appropriate for different businesses to optimize absolute returns.

The challenge is intensified by the deep division that exists at most banks. On one side are the processes and analytical approaches used for forecasting financial resource needs, sources, and returns. On the other side is the development of strategic plans for businesses. The former is typically the purview of the Treasury and Finance functions while the latter is driven by leaders of Business lines, Strategy and Financial Planning and Analysis (FP&A).

As a result, banks today are making important strategic decisions with a limited view of the intrinsic trade-offs in the allocation of scarce financial resources that affect returns at the business line, divisional, and top-of-house levels. In other words, their strategic decision-making tools, processes, and governance have not kept pace with the significantly bigger return challenges they face.
We have been working with many of our large bank clients to create this transformation in strategic bank management, through an approach we call “Strategic Financial Resource Management” (SFRM). It is a nimble framework for capturing and synthesizing key information into insights that senior executives need to make important strategic choices and to develop pricing and allocation methods for capital, liquidity, and other essential financial resources.

SFRM can be adopted and deployed by any institution but requires better analytics, integrated strategic and capital planning processes, a robust data and forecasting infrastructure, a governance model that is consistent with the new approach, and incentives aligned to return objectives and constraints. Notwithstanding these common ingredients, the specifics around how SFRM is executed will look different from bank to bank, tailored to each institution’s objectives, business mix and profile, organization and culture, data and analytics capabilities, and existing incentive structure.

We believe banks need to take a different approach to strategic planning and decision making in order to address 21st century challenges and SFRM represents a more comprehensive and sophisticated way forward. Such a sweeping transformation requires a cross-functional effort and significant “change management.” It therefore needs to be championed by CEOs, and in some cases even boards, to be successful.
WHY IS STRATEGIC FINANCIAL RESOURCE MANAGEMENT NECESSARY?

Banks have been managing their capital and liquidity since they first arose in the Renaissance of Florence. So what is different about Strategic Financial Resource Management? Simply put, standard management approaches are no longer a good fit, given the massive changes in regulatory requirements as well as banks’ diminished appetite for risk in the post-crisis era.

Exhibit 1: Today’s web of competing constraints and regulation

1. Regulators
   - Multiple objectives, different political processes

2. Post-crisis regulation
   - Vast, thousands of pages, high impact, overlapping, different across regions

3. Banks and the financial system
   - Significant impact to all businesses, new operating models, front/mid/back office redesign, substantial investments to respond to regulatory requirements

Source: Oliver Wyman analysis.
Even the most sophisticated and finance-literate executive cannot intuitively discern how strategic decisions will affect the plethora of important constraints, let alone quantify the impact of those decisions under a full range of different scenarios. While existing analytical tools can produce meaningful insights, it often takes weeks and significant manual, ad hoc effort to generate these answers – raising substantial concerns about the quality of the underlying information and the consistency of approaches and assumptions.

As a result, it is very challenging for most large banks to respond to simple questions their investors or their board could ask, such as: “What happens if GDP grows more slowly than what is assumed in your strategic plan?” or “What would be the impact of Business X not being able to gain its target market share and grow its loan book as fast or to be as large as you project?” And yet, these are the types of “what-if” questions that CEOs and CFOs need to be able to answer in order to test and, if necessary, modify their strategic decisions.

CEOs and CFOs also need to determine the risk-adjusted profitability of businesses and products after the fully-loaded costs of CET1, LCR, SLR, GSIB, TLAC, and NSFR requirements. Calculating this profitability enables them to make strategic decisions and allocate resources, with the objective of optimizing returns across many businesses, products, client segments, and geographies in an informed way.

An effective SFRM infrastructure makes it possible to meet their objectives, and generate highly insightful answers with a strategic level of accuracy under plausible scenarios (vs. CCAR-like rigor for extremely stressful scenarios with very low likelihood). Further, with the right tools and process, the answers can be generated in days or even hours, with much less manual work than under existing approaches – depending on the maturity of the data and analytical infrastructure.

Often, the inability to get to these answers quickly, easily, and accurately prevents the analysis from being done at all. This is a handicap, as better informed, more effective, and quicker strategic decisions can help raise returns, improve competitive positioning, and allow excess capital to be better redeployed. Most importantly, the better one understands the impact of different strategic moves or macro environments on financial constraints, the clearer the combination of products, segments, and geographies that leads to profitable growth with high returns.
WHAT DOES EFFECTIVE SFRM LOOK LIKE?

Exhibit 2: We believe effective strategic financial resource management requires five key elements:

**Strong analytics**
SFRM is not about sophisticated math but rather achieving a strategic level of accuracy that shows the sensitivity of returns and constraints to different business and macro scenarios at both the top of the house as well as at reasonably granular levels (such as, business unit, legal entity, and market/country).

**Integrated processes for planning, forecasting, and strategic decision-making**
Effective SFRM requires multiple functions and processes to work together in a more integrated manner. Currently, functional areas (Risk, Finance, Treasury, Business) and processes (strategic planning, capital allocation) typically operate in separate silos, often with little or no integration.

**Appropriate governance**
Just as banks need to integrate disparate processes and analytical infrastructures, a different and better-defined strategic decision-making process and governance needs to be tailored to benefit from the new combined infrastructure. That new SFRM governance needs to bring multiple functions together and incorporate processes (for example, such as setting and managing appropriate levels of risk appetite) that are typically not closely and dynamically linked to strategic planning.

**Effective infrastructure/MIS**
The analytical and modeling infrastructure for most GSiBs has been growing significantly over the last several years as institutions respond to an ever increasing and complex set of regulatory requirements, albeit in a largely ad hoc way. That infrastructure has to be integrated, streamlined, and made much more robust and automated for it to effectively support SFRM.

**Appropriately aligned incentives and performance management**
Many banks are still paying their executives and producers under traditional performance metrics (such as revenue, net income, and return on assets) with much of the capital and liquidity charges held at the “top of the house” and/or divisional levels.

In order to achieve return targets under constantly changing business and macro environments, banks need to establish and develop reliable and accepted ways of measuring and dynamically charging for financial resources at various levels (business, product, legal entity, and region). They also need to cascade bank-wide return goals down to senior executives and producers, who can optimize resources at their levels to maximize their own incentives or align with the group-wide goals in an effective manner.
HOW SHOULD SFRM APPROACHES BE TAILORED TO AN INDIVIDUAL BANK?

Effective SFRM differs from bank to bank, driven by an institution's specific strategic questions. The nature of “what if” questions and, much more importantly, the institution's challenges and constraints, also differs from bank to bank. Strategic FRM is not a math problem for which there is a known and universal solution. It is not an “optimization” but rather an analytical framework that is designed to generate strategic insights for better, more-informed decision making at line of business and “top of the house” levels. That analytical framework is shaped by the specific constraints, strategic goals, and profile of the institution. Consider two recent examples with very different starting points.

EXAMPLE 1: LARGE UNIVERSAL BANK

In the first, we advised a large universal bank that had aggressive growth targets and needed to chart a robust strategic path across a broad range of businesses and segments to achieve its targets, all the while staying within its risk appetite. While individual business and product lines had clear line of sight to their targets, the CEO and his team were seeking the most attractive combination for group-wide returns under capital constraints. We worked with the executive team to develop multiple growth paths and analyzed the respective implications of each on financial resource usage, credit/market risk, and returns under different plausible macro scenarios for the next five years. In parallel, we also analyzed how the competitive landscape is likely to evolve, in order to ground the projections. Armed with the insights coming out of our analysis, the ExCo held several day-long workshops to discuss these options and decided on the mix of product and segments to focus and invest in. More importantly, we helped the leadership team design and implement enhanced strategic planning and budgeting processes, mechanisms to charge businesses for financial resource usage, as well as an individual performance management and incentive structure that cascaded group-wide metrics several levels down in the organization.

EXAMPLE 2: GLOBALLY SYSTEMATICALLY IMPORTANT (GSIB) BANK

The second example relates to a US GSIB with binding constraints that shifted significantly following the financial crisis. This institution found itself with significant leverage exposures, in need of additional High Quality Liquid Assets (HQLA), and facing multiple other binding constraints. Given these, senior management needed to identify alternative ways of managing its balance sheet, considering different macroeconomic scenarios and the bank’s own risk appetite. Using the approach described, we helped them identify the return, financial resource feasibility, and risk profile of different growth options — enabling them to make informed strategic decisions on multiple dimensions cohesively.
These decisions included exiting certain client relationships to shrink the balance sheet, changing their product and balance sheet pricing to incorporate the “cost” of leverage and liquidity coverage ratio (LCR), changing the mix in the investment portfolio towards more HQLA to meet LCR requirements, and shifting part of the available-for-sale portfolio to held-to-maturity to reduce market-to-market volatility.

As these two examples illustrate the specific nature and shape of the SFRM effort can and will be different depending on the starting point, objectives, priorities, and constraints of your institution.

**KEY CONSIDERATIONS FOR TAILORING SFRM TO AN INDIVIDUAL INSTITUTION**

**MANAGEMENT OBJECTIVES AND THEIR PRIORITIZATION**

Virtually every manager wants high return on equity and solid growth, but there is often a trade-off between these two. In addition, shareholders and management teams have other objectives and constraints as well (related to risk appetite or business profile changes, for instance) and they also differ in their prioritization of return on equity (ROE) versus growth and other objectives.

**SET OF BINDING OR POTENTIALLY BINDING CONSTRAINTS**

Business models vary considerably, which also means that the binding constraints differ. A retail bank is likely to be bound by risk-weighted capital measures, since traditional loans tend to have high risk weights, while investment banks may be bound by any of several capital constraints, including the supplementary leverage ratio or the Comprehensive Capital Analysis and Review (CCAR) stress tests. Similarly, various liquidity measures can be more or less binding depending on the business model and operating environment. Complicating matters further, many of these constraints interact, especially capital and liquidity usage. Banks operating in multiple countries face the additional challenge of coordinating constraints that vary by geography and legal entity.

**ORGANIZATIONAL STRUCTURE AND CULTURE**

The starting point for where and how different strategic decisions are made is an important factor in designing the right approach to SFRM. This includes which strategic decisions are made at different levels of the organization. While SFRM can be valuable at multiple levels of the bank, the return on investment (ROI) associated with the effort starts to diminish beyond a certain point. After that, internal pricing of all constraints and limit setting becomes a more efficient way to guide resource allocation than the scenario analysis generated by SFRM.
With respect to culture, our discussions with industry executives, as well as our work in this area, suggest an important role for the CEO and, in most institutions, the CFO. Because of the importance of SFRM in bank strategic decision making, and the multi-functional and bank-wide organizational involvement it entails, effective SFRM requires CEO sponsorship and support.

FORECASTING INFRASTRUCTURE AND DATA AVAILABILITY

The sophistication, maturity, and level of integration of a bank’s analytical and data infrastructure are critical factors in determining the optimal way to phase in SFRM. Existing standardized platforms (such as for stress testing, budgeting, and risk management) can and should be leveraged but often cannot on their own achieve effective SFRM without proper aggregation and integration. In many instances this will expose gaps in the underlying data, planning, and forecasting infrastructures, which will then need to be patched.

INCENTIVES AND EFFICIENT INTERNAL MARKETS

There is often a significant disconnect between the metrics against which executives are compensated and the strategic objectives of the institution, particularly with regard to returns adjusted for resource usage. For example, desks, product heads, and business heads might have an important revenue and/or earnings growth objective but the link between those and ROE, net of the fully loaded costs of the financial resources needed, is more tenuous and non-linear in most cases.

Aligning individual incentives with institutional SFRM compatible objectives requires establishing a well-understood and “fair” attribution methodology for financial resources like capital and liquidity that results in charges against which the businesses can optimize their actions.
KEY SUCCESS FACTORS

While the exact nature of the SFRM effort will likely differ significantly from bank to bank, based on the factors outlined above, we find the following success factors and principles hold true across most situations.

Exhibit 3: Key success factors for SFRM

- Focus on improving efficiency of resource utilization, rather than optimization
- Ensure benefits accrue to both corporate center and the businesses
- Maintain bias toward simplification and transparency (vs. precision)
- Align effort with ongoing improvements to forecasting — use SFRM to inform efforts
- Build SFRM tools to be compatible with current/planned forecasting infrastructure
- Learn and tweak continuously — no single “right” answer
- Engage business from day one and throughout — manage center-led impression
- Shoot for “strategic” level of accuracy, appropriate for strategic planning and budgeting
- Adopt a staged approach to realizing incremental benefits over time vs. one “big bang”
- Leverage existing forecasting tools and infrastructure (for example, CCAR)

Most of these are fairly self-explanatory but one that bears emphasizing is the cross-functional nature of the effort and particularly the critical need to engage businesses from the start. SFRM cannot be like a stress exercise led by a central team staffed and led by Finance and Risk.

In addition, it’s important to understand that SFRM is strategic bank management for the 21st century and as such it calls for significant changes to strategic planning and decision making and the supporting processes, infrastructure, and governance. Such transformational changes mean that the organizational challenges are significant and require effective “change management.” To make this work, active sponsorship and leadership by the CEO and the senior-most business and functional leaders in the organization will be necessary.

CONCLUSION

Strategic Financial Resource Management is not an “optional” sophisticated analytical exercise for large and complex banks these days – it is an indispensable tool for making strategic decisions, managing binding regulatory and financial resource constraints, and allocating precious capital, liquidity, funding and other resources.
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The authors would like to acknowledge and thank Ugur Koyluoglu, Melinda Sulewski, Ilya Khaykin, Tim Xu, and numerous other colleagues for their valuable contributions.

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