IBSM Solutions

Integrated Balance Sheet Management Solutions, Inc.

Integrated Balance Sheet Management Solutions, Inc.
1267 Dorval Drive, Unit 36
Oakville, ON L6M 3Z4
Canada
+ (416) 388-3079

Value Creation, Strategic Planning and Balance Sheet Optimization - a missing link.

Most organizations have devoted significant time and resources to developing Key Performance Indicators (KPI) and Risk Adjusted Performance Measures (e.g. RAROC) with the goal of improving financial performance. Yet the link between those metrics and shareholder value creation (e.g. P/E or P/BV multiples), and Corporate Strategy (Capital/Resource allocation) is not that clear. Two fundamental questions remain unsolved:

- How to rebalance the portfolio while sustaining Revenues, EPS growth?
- How to prioritize and allocate resources to those initiatives?

Implementing a framework to inform those decisions requires developing an all-in economic profit metric (i.e. adjusted NIAT) and tracking the current as well as the projected use of and return on those resources across the different business dimensions.

Economic Profit - all-in profitability:

As the availability of resources (i.e., capital, balance sheet/leverage and liquidity) to fund new and incremental businesses becomes tighter, organizations will have to focus on identifying the current and projected sources and use of those resources, as well as the economic return on them. In order to achieve this, there are a few MIS challenges/conditions that have to be solved:

- **Interest Margin:** by now a fully loaded Funds Transfer Pricing (including LCR/NSFR related charges or Liquidity Transfer Pricing) at the product/customer level is considered best practice, and a regulatory requirement.

- **NIR recognition and Cost allocation:** at the product, customer and business line levels.

- **Credit Risk:** organizations will have to shift from incurred to life-long expected loss.

- **"Capital" allocation and cost of capital:** value creation is the result of delivering returns in excess of the cost of capital, so a key question is how much capital is required and what the related cost is.
  - Since most organizations operate above regulatory minimums, what is the correct metric, minimum regulatory or available/target capital?
  - Should other constraints (e.g. Leverage) be accounted for, even when they are not binding, and how best to do this?
  - In terms of establishing a cost, should it be a single one across the organization, or differentiated by market / business line? How often should it be reviewed?

Integrated Balance Sheet Management Solutions, Inc.
1267 Dorval Drive, Unit 36
Oakville, ON L6M 3Z4
Canada
+ (416) 388-3079

Rebalancing the Portfolio - Managing trade-offs:

While Economic Profit are the desired goal, we live and manage in a P&L dominated world. At least for F.I., no future P&L promise will drive multiples as current EPS and EPS growth do. This, in addition to limited capabilities and market growth opportunities, significantly constraints management actions in terms of rebalancing their business mix and portfolios. So how to go about driving those desired/required changes?

- In order to gain better insight, individual products are classified in three categories based on their NIAT and Economic Profit contribution: grow (positive NIAT and EP), optimize (positive NIAT, negative EP), and fix (negative NIAT and EP). The picture becomes clearer once NIAT and Capital contributions are broken down between the grow/improve/fix categories. In the following example 25% of Capital is allocated to the growth products, which generate 77% of NIAT, while a similar amount (26%) is allocated to products that generate only 4% of NIAT, an easy call in terms of NIAT/Capital reallocation.

Link to Market Opportunities and Growth Targets:

- The next step would be to review the Strategic or Annual growth targets (risk appetite and resource allocation) under the same approach. In this case, the highest growth is projected to be in products with poor economics, which unless supported by specific improvement actions / strategic goals should be challenged and capital/resources redirected.

Economic Profit measure (all-in)

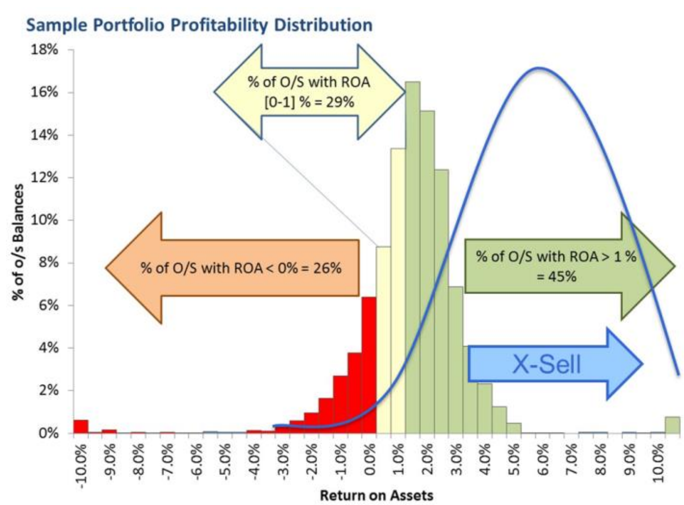
Product	o/s Balance	Alloc. Capital	Adj. NIAT	Eco Profit	Strategy
Asset Product A	8,000	1,000	50	(50)	!
Asset Product B	1,000	200	(15)	(35)	✗
Asset Product C	2,500	150	30	15	✓
Asset Product D	4,000	400	150	110	✓
Retail DDA+Sav	2,500	50	25	20	✓
Retail TDs	2,200	25	10	8	✓
Non-Retail DDA+Sav	2,200	50	50	45	✓
Non-Retail TDs	2,000	25	-	(3)	!
Treasury	1,000	200	10	(10)	!
Wealth	-	100	35	25	✓
Trading	-	200	35	15	✓
Other	250	250	(100)	(125)	✗
TOTAL		2,650	280	15	

Capital Allocation and EPS trade-off

	Grow ✓ (NIAT +; EP +)	Optimize ! (NIAT +; EP -)	Fix ✗ (NIAT -; EP -)
- % Revenue	77%	19%	4%
- % Capital	25%	49%	26%

Growth targets and Market Potential

Strategic Plan (CAGR)	Grow ✓	Optimize !	Fix ✗
Asset Product A		10.0%	
Asset Product B			20.0%
Asset Product C	5.0%		
Asset Product D	5.0%		
Retail DDA+Sav	10.0%		
Retail TDs	10.0%		
Non-Retail DDA+Sav	10.0%		
Non-Retail TDs		24.2%	



Even at a high level, having a coherent approach for performance measurement, capital and balance sheet allocation, and a link to growth targets, should benefit most entities in driving and mitigating the impact of the required changes.

Please contact us if you require assistance in developing / implementing your Balance Sheet Optimization framework.