RISK-RETURN ANALYSIS FOR FINANCIAL SERVICES

A case study on a sample of Italian banks and their ability to reward Risk Capital

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Agenda

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Background

- As regulated financial intermediaries, banks face stringent capital requirements due to the risks they undertake, ensuring financial market stability and clients and investors protection.
- Given that capital is a limited resource, it becomes a crucial factor in guiding banks' business decisions in line with risk and mitigation strategies.
- Top Management's growing focus on risk-taking, risk management, and mitigation is driving the industry to allocate capital more efficiently across risk sources and business areas (business lines, client segments, products, and markets) to maximize shareholder returns according to their risk strategies.
- Regulation has gradually shifted banks' objectives from solely profitability-focused to prioritizing liquidity and capital ratios, evolving towards a risk-return framework and the development of risk-based compensation systems.

Our analysis

- TNP Italia carried on a study on the risk capital remuneration capabilities of a sample of Italian banks, analyzing performance and capital required (RWAs) by Business Line (Retail Banking, Corporate & Investment Banking, and Wealth Management) to calculate the Risk-Adjusted Performance Indicator (RORAC) based on financial statements from the last three years (2021-2023).
- This analysis serves as a starting point for a more detailed risk-return performance measurement, which can be further refined by product, client subsegment, geographical area, etc., using specific corporate databases.
- A Value-Based Management framework, tailored to various levels of granularity, becomes an essential tool for Top Management: it enables more effective allocation of the bank's risk capital, aligns risk mitigation strategies with shareholder value creation, redirects business plans and redefines commercial strategies while providing an additional metric for risk-reward compensation systems.

Executive summary

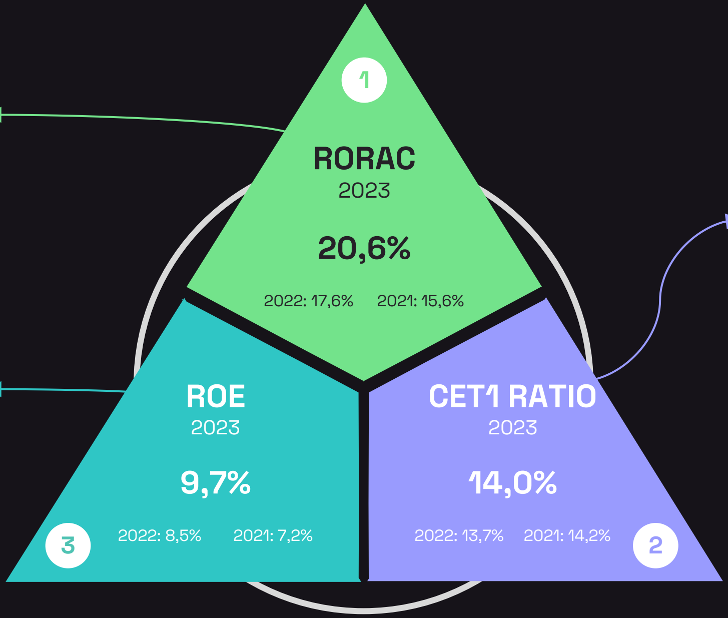
Analyzing a select group of Italian banks* that provides detailed insights on their performance and Risk-Weighted Assets (RWAs) by Business Line in the period 2021-2023, we observed a positive trend in Return on Equity (from 7,2% to 9,7%) and RORAC (from 15,6% to 20,6%), all while maintaining substantial stability in Capital and Liquidity ratios. By Business Line, Retail Banking saw a significant increase in Risk-adjusted performance (from 14,8% to 23,6%), while Corporate and Investment Banking (CIB), after an underwhelming 2022, remained steady with its 2021 results (17% in 2023 vs. 17,7% in 2021). Wealth Management, which includes Asset Management companies, ensured outstanding RORAC performance, reaching 83,6% in 2023.

RORAC by Business Line

	2023	2022	2021
Retail B.	23,6%	17,8%	14,8%
Corp.& Inv. B.	17,0%	10,4%	17,7%
Wealth M.	83,6%	72,8%	94,6%

Financials

	2023	2022	2021
ROA	0,7%	0,6%	0,6%
Cost/Income	53,8%	54,6%	55,0%



Capital & Liquidity ratios

	2023	2022	2021
Tier 1 ratio	14,5%	14,1%	15,1%
TCR	16,9%	16,3%	17,5%
LCR	147%	139%	142%
NSFR	116%	112%	114%
Leverage	6,6%	6,6%	6,9%

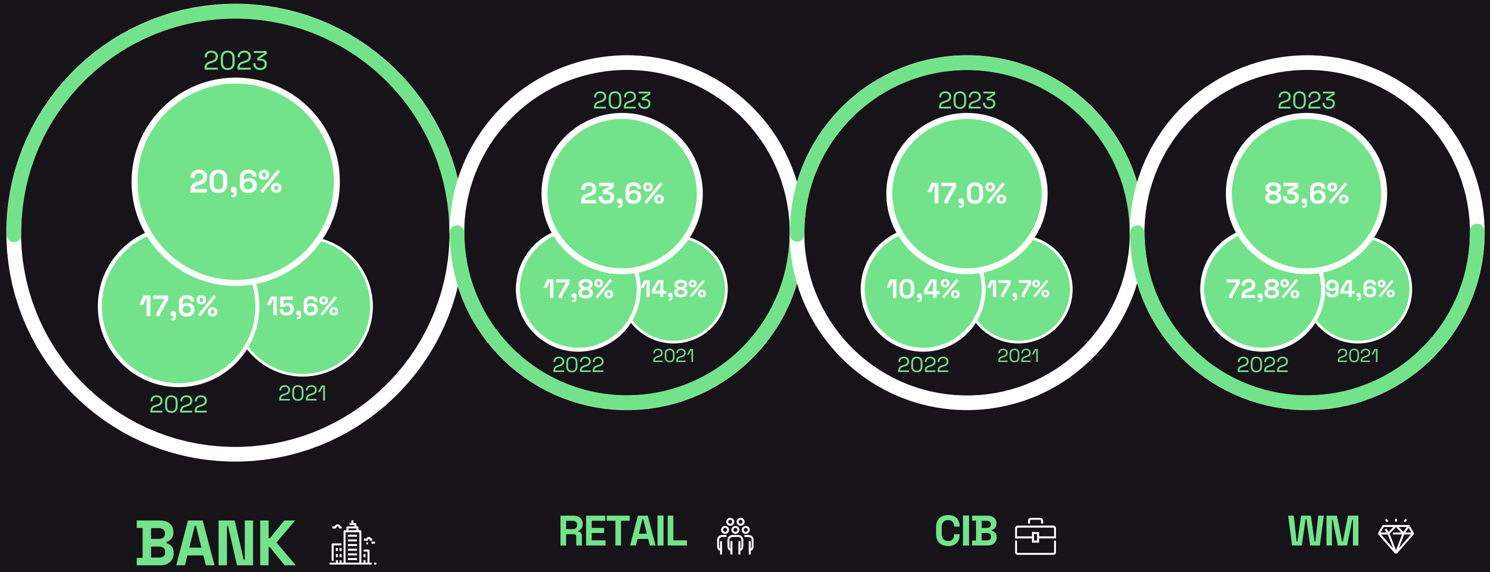
LEGEND:

- RORAC = Return on Risk-adjusted Capital
- ROA = Return on Assets
- TCR = Total Capital Ratio
- LCR = Liquidity Coverage Ratio
- NSFR = Net Stable Funding Ratio
- Leverage = Tier 1 Capital to total exposure

* Intesa San Paolo Group, Mediobanca Group, BNL

Analysis by RORAC (Return on Risk-Adjusted Capital) indicator

With detailed data provided by our sample (two banking groups and one Italian bank) for the period 2021-2023, we conducted a risk-return performance (RORAC) analysis for the main Business Lines (Retail Banking, Corporate & Investment Banking and Wealth Management). At consolidated level, the positive trend of RORAC is confirmed with its growth from 15,6% in 2021 to 20,6% in 2023. At Business Line level, we identified a positive trend for Retail Banking (from 14,8% to 23,6%), a stability for Corporate & Investment Banking (from 17,7% to 17% with a fall in 2022 (10,4%)) and a slight decrease of Wealth Management even though it started from an extraordinary level (from 94,6% to 83,6%).

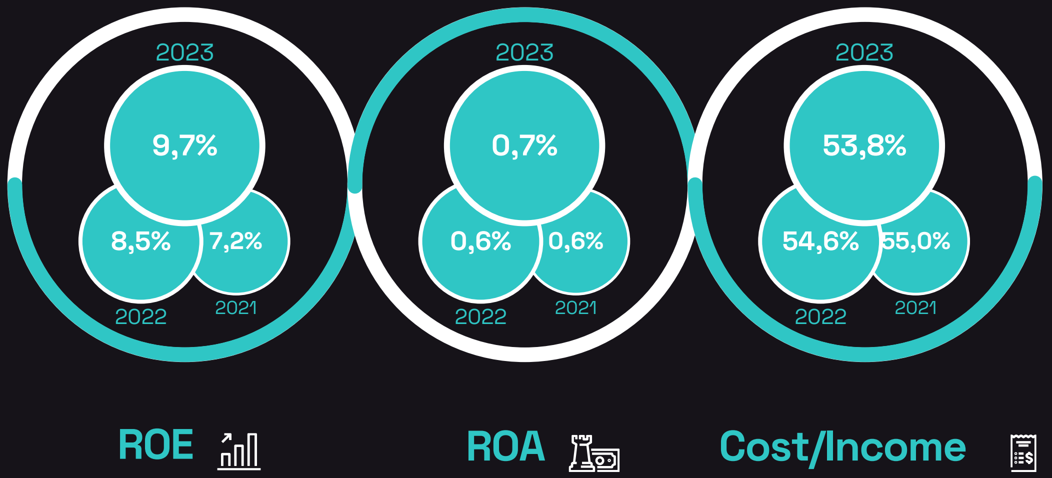


LEGEND:

- CIB = Corporate & Investment Banking
- WM = Wealth Management

Analysis by Financial indicators

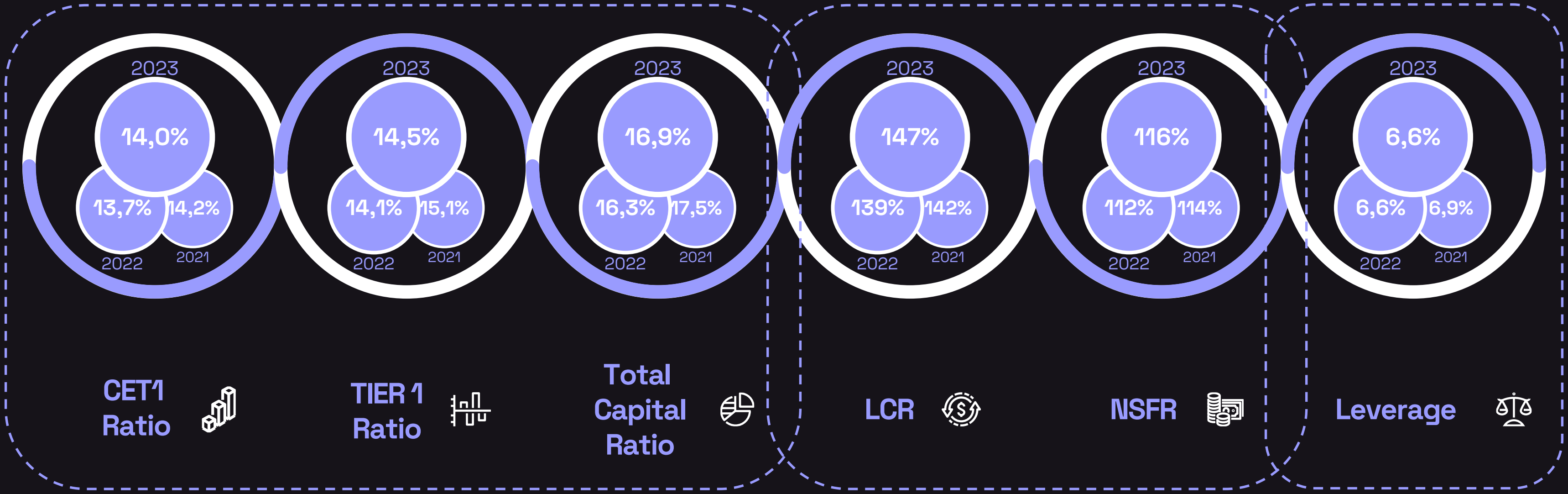
Remuneration of Shareholder Equity of the sample has progressively increased over the last three years, from 7,2% in 2021 to 9,7% in 2023, while the Italian market showed an increasing ROE from 6% (2021) to 12,3% (2023)*. In parallel we noted a slight decrease of the running costs, with a cost/income ratio moving down from 55% to 53,8%, outperforming the entire Italian market which moved from 67% (2021) to 55,7% (2023)*. Return on Assets (ROA) remained relatively stable in the three years, from 0,6% to 0,7%.



* Source: Bank of Italy

Analysis by Capital & Liquidity ratios

The various capital ratios of the sample remained stable over the three-year observation period, with CET1 ratio at 14% and Total Capital Ratio at 16,9% in 2023.
In this time frame the Italian market showed stability as well, even performing slightly better, with CET1 ratio at 15,6% (2023) and Total Capital ratio at 19,4% (2023)*.
Stability was confirmed also for Liquidity ratios: in 2023 LCR stood at 147% (Italian market average: 182,7%*) while NSFR reached 116% (Italian market average 131,3%*).
Leverage ratio slightly decreased from 6,9% in 2021 to 6,6% in 2023.



Capital ratios | Liquidity ratio | Leverage ratio

* Source: Bank of Italy

In search of shareholder value

Regulators enforce various quantitative requirements on banks, such as minimum capital and liquidity ratios, to ensure financial market stability and protect clients.

However, beyond merely meeting capital ratios, banks have recognized the importance of efficient capital management, focusing on performance with respect to risks incurred (RWAs) at business unit, client segment and product level.

Achieving this demands advanced methodologies and management tools, supported by detailed databases with strong data quality in place.

An integrated risk-return performance measurement system is essential for monitoring and communicating bank's results to stakeholders, supporting budget strategy and financial resources planning.

Additionally, adopting remuneration systems based on risk criteria aligns with Supervisory Authority expectations and harmonizes business unit managers' goals with those of shareholders, fostering value creation and capital strengthening.

TNP Italia

We are a European consulting firm that assists leading companies in their strategic, operational, regulatory and digital transformations. Our aspiration is to become the leading independent consulting firm in Europe, Africa, India, and the Middle East by 2030.

KEY FIGURES (2024)

- **1.000 consultants** around the world
- **€130 million in revenues**
- Active projects in more than **25 countries**
- **4 Regions**
  - **Europe**: Paris, Lyon, Marseille, Monaco, Luxembourg, Milan, Geneva, Frankfurt, Bilbao
  - **North and West Africa:** Casablanca, Tunis, Abidjan
  - **India-Middle East:** Cochin, Mumbai, Delhi, Dubai
  - **United States:** Philadelphia

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Disclaimer

Our analysis, which uses official public data, is based on assumptions and proprietary methodologies of TNP Italia. These data have not been audited, reviewed, or subjected to any other type of testing to validate the reasonableness of what has been made publicly available by the banks. Any inaccuracies or incompleteness could have influenced the results of our analysis. The purpose of this document is purely educational and presents information and data of a general nature. This report should not be considered a guide for any type of investor: in such cases, it is recommended to consult professional financial advisors.
Data source: 2023, 2022 and 2021 Financial Statements and Pillar III, Bank of Italy statistics.

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