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Report

Creating Value in Banking 2008

Managing Shareholder Value in Turbulent Times

The Boston Consulting Group

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Note to the Reader

Managing Shareholder Value in Turbulent Times is The Boston Consulting Group's (BCG's) sixth annual study of shareholder value creation in the banking industry. Like previous reports, it describes the state of the industry—showing top performers by country, segment, and size—and quantifies the drivers of value creation for both one-year and five-year performance. In addition, this year's study takes a close look at how banks can implement an integrated approach to strategy development—one that places total shareholder return (TSR) at the heart of the process.

This report covers a large sample of banks that represents more than 75 percent of the total market capitalization of the global banking industry. Whenever possible, we measured performance in local currency, which best reflects underlying value creation. Where comparisons between banks required a single-currency perspective, we used data based on U.S. dollars.

The report focuses on banks' performance in 2007. It does not take into account developments that have occurred since December 31, 2007.

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Executive Summary

The subprime crisis left its mark on the banking industry in 2007. Last year's report on value creation focused on "bigger, better banking." Since then, shock waves from the subprime crisis have had a significant impact on the industry. A decent start to the year masked a precipitous drop in market capitalization and performance in the second half. The banking sector's market capitalization increased by only 2.4 percent to $8.3 trillion—a dramatic change from 2006, when growth topped 31 percent. The industry's total shareholder return (TSR) plummeted from 26.1 percent in 2006 to 1.7 percent in 2007. The average TSR for all industries, by comparison, was 15.2 percent.

A gaping performance divide separated ten major developed markets from the rest of the banking world. Banking TSRs in these developed markets fell by an average of about 32 percentage points in 2007, to about -13 percent. Banking industries outside of the ten major markets achieved a TSR of about 27 percent. The average banking TSR in BRIC countries—Brazil, Russia, India, and China—was an astounding 50 percent.

Australia's banking industry posted the only positive one-year TSR among the major developed markets. Japan's banking industry had the lowest one-year TSR, but it also suffered the mildest decline. Its TSR dropped by 9.8 percentage points in 2007, while banking TSRs fell by as much as 40 percentage points in other countries. Germany's banking sector had the strongest five-year TSR, at 19.8 percent, while the banking industries in Italy and Spain continued to climb steadily in the ranking of long-term performance.

Only one segment, asset managers, had a positive TSR in 2007. Universal and investment banks fared much better than consumer- and mortgage-finance companies, which had the most direct exposure to the upheaval. Mortgage finance had the lowest TSR in 2007, at -36.2 percent, and the only negative five-year TSR. Consumer finance posted the second-lowest TSR, at -27.1 percent.

The crisis led to a shake-up among the largest banks, measured by market capitalization, with several Chinese banks at the top of the ranking. While North American and Western European banks lost $695 billion of market capitalization, other banking sectors, notably those in BRIC countries, gained $888 billion. The biggest Chinese banks—ICBC, China Construction Bank, and Bank of China—claimed three of the top four places in 2007, while the three largest U.S. banks—Citigroup, Bank of America, and JPMorgan Chase—lost ground.

Five-year performance: equity growth continued to make the greatest contribution to banks' TSR. Growth is a central theme in banking strategy, as evidenced by the rise of the "emerging titans" and ongoing consolidation in banking sectors around the world. Growth, however, does not always translate directly into positive value creation; some banks with high rates of equity growth have had significant share dilutions and declines in PE multiples. ROE made a smaller contribution to banks' profit. In 2007, banks' five-year ROE increased by only 4.2 percent and accounted for one-fifth of the overall change in profit. Investor confidence—measured by the change in the PE multiple—remained the only negative driver of long-term TSR. Free-cash-flow yield made almost the same contribution to five-year TSR as it did in 2006.

One-year performance: banks' profitability plummeted. In 2007, the industry's ROE decreased 4.5 percentage points, to 13 percent, while its cost of equity grew 1.8 percentage points, to 12.6 percent. As a result, the profitability spread almost disappeared, falling from 6.7 to 0.4 percentage points. At the same time, the industry grew its equity by 12.7 percent, to $3.3 trillion, largely due to growth in emerging markets. The net effect of a narrower profitability spread and banks' moderate growth was a considerable decrease in after-tax profits, which fell for the first time since 2003, to $406 billion.

In turbulent times, having a clear and robust TSR strategy is critical. The crisis should prompt banks to revisit their strategies for creating shareholder value. Banks can gain more control over their plans for value creation by pursuing an integrated approach that fuses financial, investor, and business strategy and focuses on an explicit TSR goal. A TSR approach recognizes that business strategy choices need to be informed by financial and investor strategy at the outset—not after a business strategy has been decided. To develop an integrated value-creation strategy, four steps are essential: set an initial TSR goal, build a fact base, create strategy scenarios, and apply an agreed-upon TSR strategy.

The State of the Banking Industry

The subprime crisis left its mark on the global banking industry in 2007. The crisis was sparked by a sharp downturn in the U.S. housing market, which began in late 2006 and escalated into a worldwide financial crisis within a year. This trend carried into 2008, with a first quarter characterized by massive write-downs, weakening stock markets, and the biggest cut in interest rates by the U.S. Federal Reserve in 25 years. With many forecasts predicting that the worst is not over, banks face a challenging year. (See the sidebar "Responding to the Subprime Crisis," on page 10.)

For the first time in five years, banks were unable to sustain double-digit growth. In 2007, banking market capitalization increased by only 2.4 percent, to $8.3 trillion—a dramatic change from 2006, when growth topped 31 percent. (See Exhibit 1.) The industry's total shareholder return (TSR), which includes capital gains and free-cash-flow yields, plummeted from 26.1 percent in 2006 to 1.7 percent in 2007.

The banking sector's performance in 2007 did not reach the depths seen in 2001 and 2002, but the effects of the subprime crisis were somewhat muted: a respectable start to the year masked a precipitous drop in market capitalization and performance in the second half. From January through June, banking market capitalization grew by 5.7 percent. In the second half of the year, banks lost $269 billion in market capitalization. (See Exhibit 2.) North American and Western European banks together lost $695 billion of value—more than the GDP of the Netherlands. The downturn was also cushioned by the exceptional growth of banking industries in BRIC countries—Brazil, Russia, India, and China—and other emerging markets. In 2007, banks in the BRIC countries increased their collective market capitalization by $753 billion, raising their share of global banking market capitalization from 11 percent to 19 percent. The average banking TSR in these four countries was an astounding 50 percent. (For more on these emerging markets, see the sidebar "The Continuing Growth of BRIC Banking," on page 17.)

The performance of the banking sector dropped far below the all-industry average. In the recession that followed the Internet bubble, in early 2000, the banking industry's TSR managed to stay above the all-industry average. And when banks bounced back in 2003, they did so with extraordinary growth and performance.

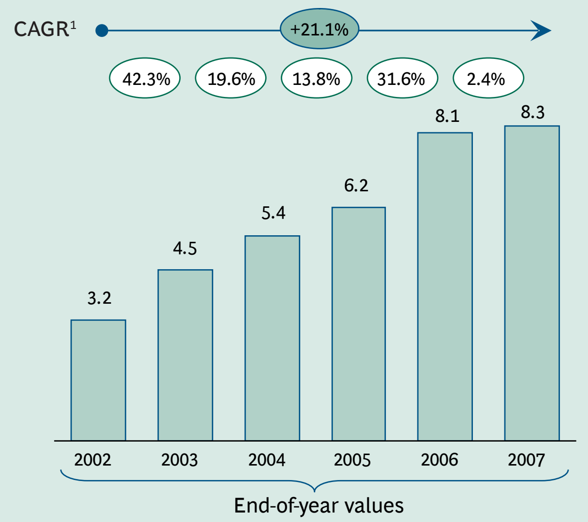
The current situation is quite the opposite. Rather than resisting the downturn, banks are leading it. (See Exhibit 3.) In 2007, the banking industry had the second-largest decline in TSR among the 14 major industries in our study—more than 24 percentage points—and its five-year performance continued to decline relative to other sectors. In 2003, banks had the fourth-best long-term TSR among the 14 industries. By 2007, the industry's five-year TSR had fallen to eighth place.[1]

The crisis has taken a heavy toll on banks, but the cooling economic climate has clearly affected other sectors as well. Half of the 14 industries experienced double-digit falls in average TSR.

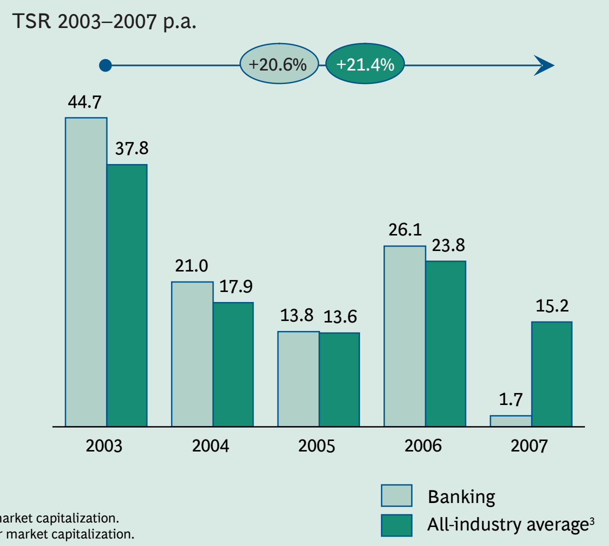
1. For more information on industry rankings, see the BCG report *Avoiding the Cash Trap: The Challenge of Value Creation When Profits Are High.*

Exhibit 1. The Subprime Crisis Took a Toll on Banks' Growth and Performance in 2007

Total market capitalization ($trillions)



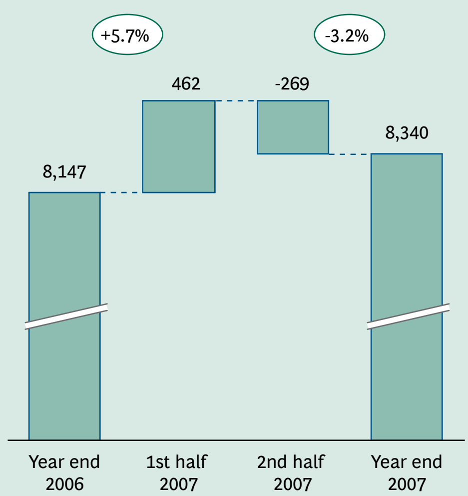
Total shareholder return[2] (%)



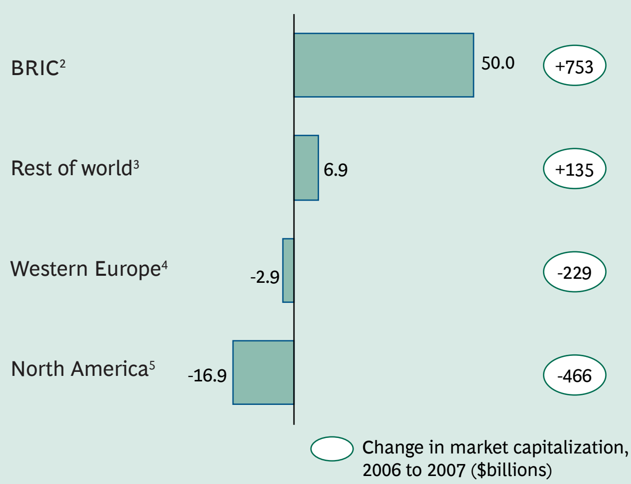
1. Compound annual growth rate. 2. TSR comprises capital gains and free-cash-flow yields. 3. Weighted by market capitalization.
Note: Percentage changes in market capitalization were calculated using precise, rather than rounded, figures for market capitalization.
Sources: T.F. Datastream; BCG analysis.

Exhibit 2. Banks' Market-Cap Gains in the First Half of 2007 Masked Second-Half Losses

Total market capitalization ($billions)



Total shareholder return,[1] 2007 (%)



1. TSR comprises capital gains and free-cash-flow yields. 2. Brazil, Russia, India, China. 3. Comprises 31 countries. 4. Benelux countries, Denmark, Finland, France, Germany, Italy, Norway, Spain, Sweden, Switzerland, United Kingdom. 5. United States and Canada.
Note: All TSRs were calculated after conversion to U.S. dollars.
Sources: T.F. Datastream; BCG analysis.

Responding to the Subprime Crisis

Market bubbles are a product of flawed beliefs that rashly assume that this time it's different. They also leave behind a ruinous aftermath that obscures genuine opportunities. The tech-stock bubble was devastating, for example, but it was hardly the death knell for the Internet. The mortgage crisis is no different. Strip away the irrational behavior that led to the turmoil, and market participants will find ways to prevent the crisis from recurring, clearing the way for strategies to pursue profitable growth.

Flawed Beliefs

The unbridled growth of the U.S. mortgage market stemmed from three widely held misconceptions. Everyone believed in the same market utopia, where the creditworthiness of homeowners was strong, investors in mortgage securities were sophisticated, and credit risk was widely distributed.

The first belief was perhaps the most reasonable. After years of limited credit losses, homeowner credit did, indeed, appear to be strong. The perception of healthy homeowner credit drove mortgage spreads lower, making it easier to extend financing to marginal borrowers, who in turn appeared to have strong credit. U.S. subprime mortgage originations increased by an average of 38 percent per year from 2001 to 2006. (See the exhibit on page 11.)

The looming crisis did not go entirely unnoticed. The U.S. Federal Reserve picked up on the momentum of high-risk lending and began raising the benchmark rate in late 2004. Despite this move, more than $1 trillion continued to flow into subprime mortgages, many of which had low "honeymoon" rates that increased after two years.

The second belief provided even more false comfort. With unprecedented access to data and analytics, investors were seen to be exceptionally sophisticated. Advanced financial technology meant that risk could be finely tailored to their specific needs. Strengthened by credit insurance and blessed by rating agencies, this risk was assumed to be nearly bulletproof. Consequently, the capital applied against it was minimized.

Finally, participants in the mortgage market believed that risk was widely distributed. Even if credit worsened and analytics failed, the absence of concentrated risk would prevent systemic problems. This conviction, more than any other factor, explains why people—instead of being wary of a market bubble—believed that this time it was different. In reality, investment banks and many universal banks had acquired material risk exposure.

The flaws in these beliefs became clear once home prices began to tumble. The default rates on adjustable mortgages soared, and not just in the subprime category: in the third quarter of 2007, nearly half of all foreclosures in the U.S. market were in lower-risk classes. (See the exhibit on page 11.) The industry's creative use of complex financial instruments led to a contagion effect, with the subprime crisis quickly spreading beyond credit risk, the mortgage sector, and the United States. Write-downs have exceeded $180 billion, and the damage has still not been fully contained. Some forecasts show losses topping $400 billion.

The Consequences

The full impact of the crisis has yet to unfold, making it impossible to tell exactly how it will change the banking industry. The short-term consequences, however, are obvious: massive write-downs, the evaporation of enormous amounts of market capitalization, a shake-up among the titans, and layoffs in investment banks and the investment-banking arms of universal banks. In addition, the securitization market has dried up, affecting M&A activity that relies heavily on debt, and numerous private-equity deals are on hold until the smoke clears.

Over the medium and long term, the effects of the crisis will be profound. The outlook for retail banking is marred by limited prospects for growth and high profitability. Excessive household debt will limit retail lending in some markets, while corporate lending is likely to continue suffering as a result of the credit crunch. For their part, investment banks will need to prioritize operational resilience as much as they prize innovation, given the way their infrastructure could not keep up with their aggressive growth. It is also likely that banks—particularly universal banks with large balance sheets—will reinforce the basics and focus on business flow and lending offerings over proprietary trading activities.

Some activities that have been affected in the short term will recover. For example, the crisis will not be the end of securitization, since its basic logic remains intact. Likewise, private-equity deals will prove resilient. The private-equity business model relies more on creating value through performance improvement than through leverage.[1]

Moving Forward

Although it is still difficult to gauge the full impact of the crisis—on both banks and the economy as a whole—it is clear that its resolution will require structural and lasting changes in the way banks evaluate their risks. Banks that start this process soon will gain competitive advantage, particularly if they address a comprehensive range of risk-management issues:

- **Reassess your risks.** In the short term, banks need greater clarity of the exact exposure of their portfolios. Each bank should create a crisis taskforce to reassess its current risk profile using a scenario-based approach.

- **Improve transparency through better risk assessment and reporting.** Banks and investors should not rely solely on rating agencies, for example. In addition, qualitative aspects of risk should be better integrated with a purely quantitative approach, which has shown its limits.

1. See the BCG report *The Advantage of Persistence: How the Best Private-Equity Firms "Beat the Fade."*

- **Manage capital more effectively.** The high cost of capital will force banks to find ways to manage their capital more effectively, in compliance with Basel II and local regulatory frameworks. Furthermore, the allocation and redistribution of economic capital across business divisions need to be reassessed on a continuing basis.

- **Test the quality and resilience of your infrastructure and processes.** Investment banks sometimes lack the infrastructure to manage the activities of hedge funds and structured products. Banks should develop actionable crisis scenarios to ensure a coordinated, timely response to credit defaults with hedge funds or other risky counterparts.

- **Develop a more robust credit-pricing framework.** Risk-based pricing is critical across all asset classes and business areas. Credit pricing should integrate the overall cost of capital, which includes not only credit risk but also liquidity risk.

- **Change your risk management model.** The imposition of too many controls has created a fragmented control environment. Banks should adopt a model that has fewer but better controls; that allows them to detect—not simply measure—the potential impact of operational risk; and that ensures single-point accountabilities.

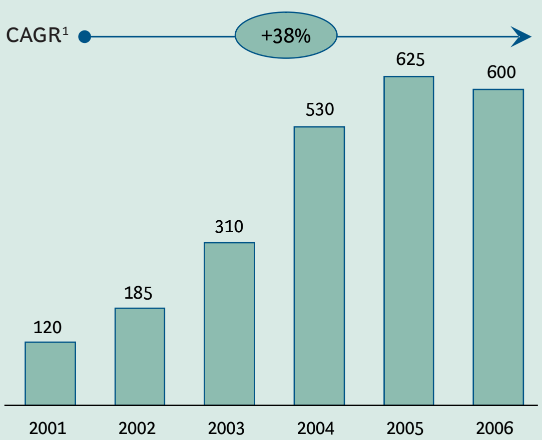
- **Review your approach for managing bad debt.** Recent BCG experience shows that the recovery of bad debt can be increased by around 15 percent through improved techniques and processes. Best practices include introducing a risk-based prioritization method of early arrears using Basel II data.

- **Prepare for increased regulatory scrutiny.** The crisis is bound to lead to discussions about further regulations. Regulators will want to enact new measures to keep players from increasing systemic risk in the financial sector.

As they focus on containing the damage of the crisis and taking steps to avoid similar problems in the future, banks should not lose sight of the potential to acquire undervalued assets and franchises. The current environment provides a rare opportunity to structurally reposition their businesses by obtaining new capabilities for the future. The postcrisis landscape is already being shaped by restructuring and consolidation activities in Europe and the United States.

Subprime Mortgage Originations Increased Significantly from 2001 to 2005

Estimated U.S. subprime originations, 2001–2006 ($billions)

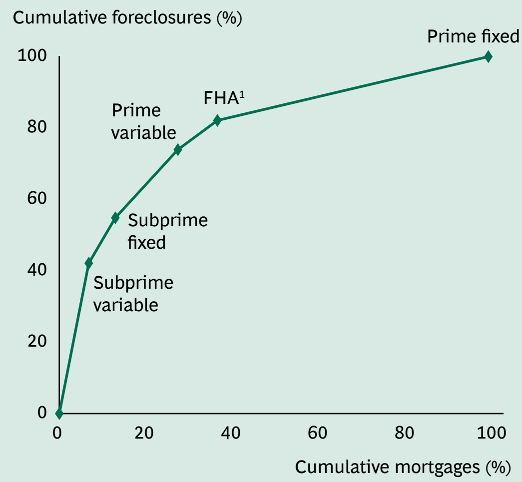


Many of the loans originated in 2005 were scheduled to have their rates reset in 2007

1. Compound annual growth rate.
Source: BCG analysis.

Subprime Mortgages Were More Vulnerable to Foreclosure

Type of mortgage, as a percentage of U.S. foreclosures and total mortgages, 3rd Q. '07



1. Refers to mortgages insured by the Federal Housing Administration.
Sources: Mortgage Bankers Association; Bloomberg; BCG analysis.

Country Performance

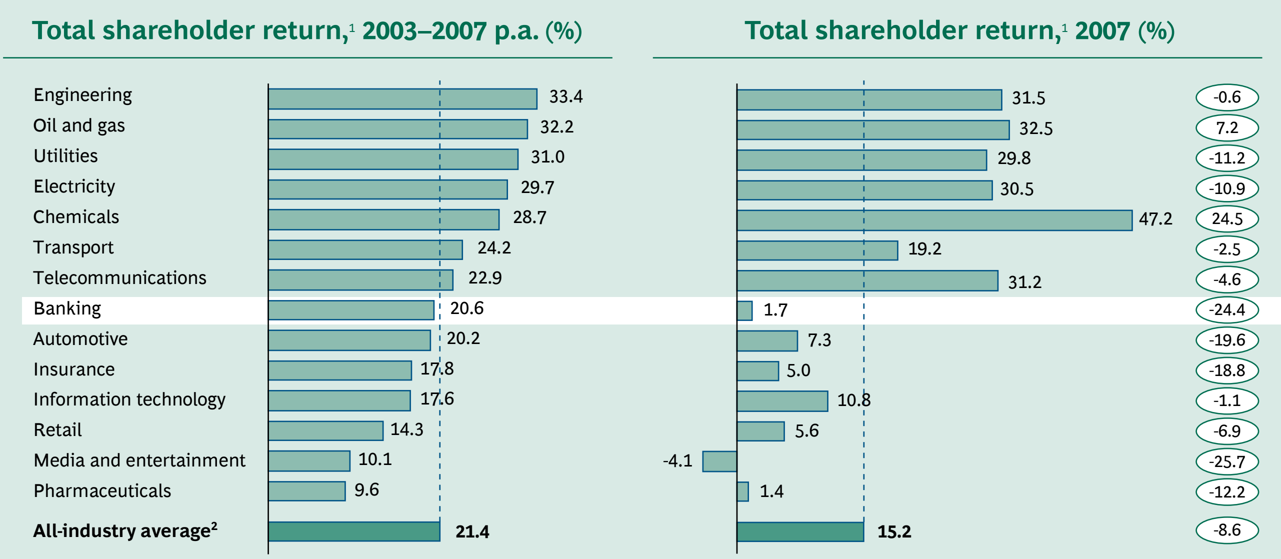
A gaping performance divide separated the ten major developed markets from the rest of the world. Banking TSRs in these developed markets fell by an average of about 32 percentage points in 2007, to around -13 percent—well below the global banking average of 1.7 percent. Banking industries outside of the ten major markets achieved a TSR of about 27 percent.

Five-year TSR: among major developed markets, Germany's banking sector jumped from eighth to first place, with a five-year TSR of 19.8 percent. (See Exhibit 4.) Its above-average performance in 2007 was due in part to some of its largest players' having avoided the full brunt of the crisis. Commerzbank was only moderately affected. Deutsche Bank, on the other hand, was more vulnerable because of its investment-banking activities. Its write-downs topped $3 billion. However, the bank's losses were still well below some of the hits taken by several comparable banks in Europe and North America. In Germany, banks that were most severely affected by the crisis either accounted for a small part of the sector's total market capitalization or were not listed. Its five-year TSR notwithstanding, the German banking sector is feeling the effects of the crisis, and another round of consolidation is anticipated.

Two other major banking sectors, in Italy and Spain, continued to climb in the five-year TSR ranking. Spain's banking sector ranked seventh in 2005, fifth in 2006, and third last year. Past improvements to long-term TSR were fueled by the enhanced profitability and growth of major players. The country's largest bank, Banco Santander, generated a TSR of 8.1 percent last year, in part because it was unaffected by the subprime crisis but also because of its successful expansion into Latin America. Its performance helped offset the negative TSRs of smaller players.

Italy's banking industry has risen even more dramatically. Its five-year TSR ranked ninth in 2005, third in 2006, and second last year. Its performance owes less to its showing in 2007 and more to the above-average TSRs achieved in 2005 and 2006, which were mainly driven by M&A activity. The industry's gains were protected by a combination of limited exposure to the crisis and strong performance

Exhibit 3. The Banking Industry's TSR Fell Sharply in 2007, but the Crisis Affected Many Sectors



1. TSR comprises capital gains and free-cash-flow yields. 2. All-industry TSR is weighted by market capitalization.
Note: All TSRs were calculated after conversion to U.S. dollars.
Sources: T.F. Datastream; BCG analysis.

Change, in percentage points, from 2006 TSR by major players. Intesa Sanpaolo reported no major losses. UniCredit's write-downs were relatively minor. Its operating profits grew twice as fast as revenues, especially in the emerging markets of Central and Eastern Europe.

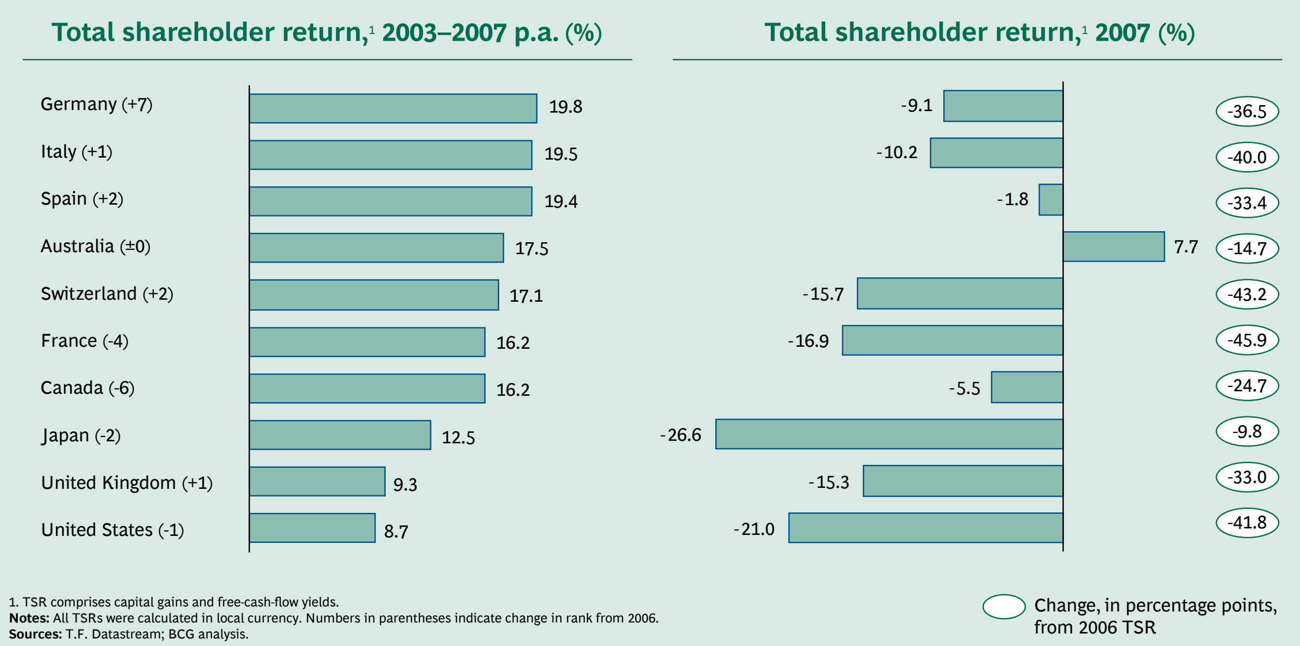
One-year TSR: Australia's banking industry posted the only positive TSR among the ten major developed markets in 2007. Its performance was outstanding but not necessarily surprising. Since 2003, its five-year TSR has been among the five best across the major markets. Australia's economic climate has been robust, and its banking sector largely unaffected by the subprime crisis. Moreover, some of Australia's major banks have posted strong performance. Conditions remain favorable for the sector in general. Growth in household income is healthy, and a government-mandated retirement-savings program is spurring individuals to play a more active role in managing their wealth.

Japan's banking industry had the lowest one-year TSR among the major developed markets, but it also suffered the mildest decline. Its TSR dropped by 9.8 percentage points in 2007, whereas banking TSRs in several other countries fell by more than 40 percentage points. Three of the country's biggest banks—Mitsubishi UFJ Financial Group, Sumitomo Mitsui Financial Group, and Mizuho Financial Group—lost a total of $82.4 billion, or about 28 percent of their combined market capitalization, compared to 2006. The net income of the Japanese banking sector declined, as did its expectation premium, following the sudden downturn of TSR in 2006. The banking sector in Japan will continue to face challenges. Economic growth is restrained; concerns about declining exports are mounting, given the situation in the United States; and corporate lending is growing slowly.

Segment Performance

Only one segment, asset managers, posted a positive TSR in 2007. It was a sharp contrast to 2006, when only one segment posted a *negative* TSR. The turmoil that began in the United States has permeated the financial services sector, but to varying degrees. Universal and investment banks fared much better than consumer- and mortgage-finance companies, which had the most direct exposure to the upheaval in the United States.

Exhibit 4. The Crisis Weighed Heavily on Banks in Major Developed Markets



1. TSR comprises capital gains and free-cash-flow yields.
Notes: All TSRs were calculated in local currency. Numbers in parentheses indicate change in rank from 2006.
Sources: T.F. Datastream; BCG analysis.

The warning signs appeared in 2006, when the consumer- and mortgage-finance segments had the lowest one-year TSRs (consumer finance had the only negative TSR that year). In last year's report, we attributed these relatively weak TSRs to a cooling housing market and concerns about consumer spending. Since then, the downturn has weighed heavily on these segments. Mortgage finance had the lowest TSR in 2007, at -36.2 percent, and the only negative five-year TSR. Consumer finance had a TSR of -27.1 percent. (See Exhibit 5.)

Investment and universal banks had TSRs of -5.5 and -6.1 percent, respectively. The signs of trouble—at least from a performance perspective—were not evident in 2006, when investment banks boasted the highest one-year TSR, at 32.7 percent, and universal banks had the strongest five-year performance, at 23.5 percent. Both segments have since suffered from their exposure to the financial crisis.

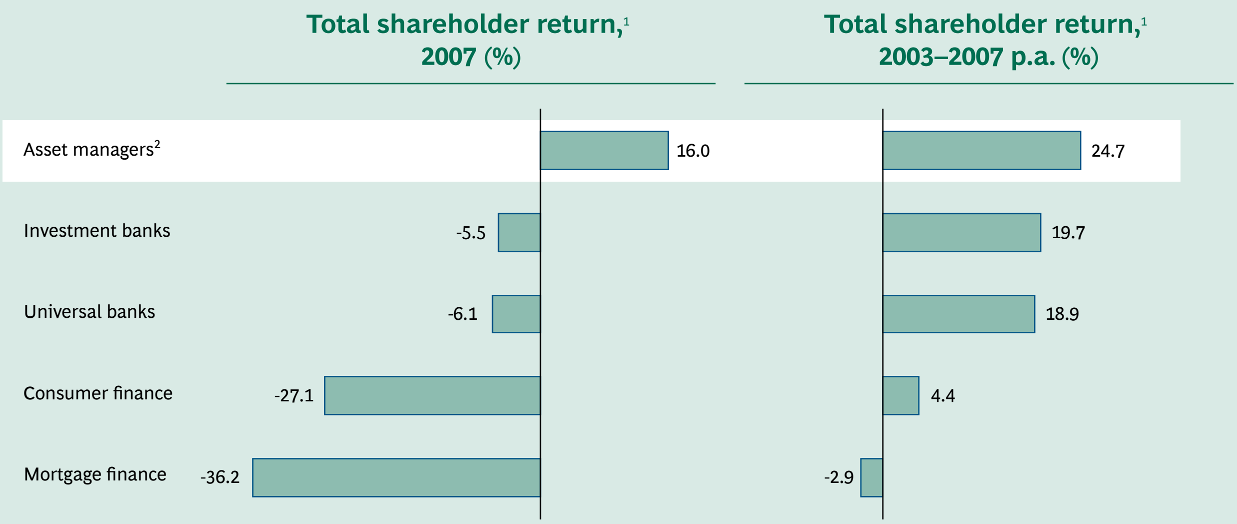
The five largest investment banks in our study accounted for 53 percent of the segment's market capitalization. Of these, Goldman Sachs had the only positive TSR in 2007. It was also the only one that managed to preserve its pre-tax profit margin and significantly increase revenues in 2007. (See Exhibit 6.) Goldman Sachs benefited from an exceptional risk-management culture, which allowed the bank to set in place well-timed measures that helped mitigate losses associated with subprime loans.

The intrinsic diversification of universal banks was meant to shield them from troubles in any one market or business, but many of the larger players had to digest massive write-downs caused by their investment-banking arms and mortgage-finance businesses. Eight of the ten largest universal banks had negative TSRs.

Asset managers had the strongest one- and five-year performance. With their reliance on management fees, these players avoided direct losses from the souring mortgage market. Still, the indirect effects of the crisis caused the average TSR of asset managers to fall from about 24 percent in 2006 to 16 percent in 2007. Investors are becoming more risk-averse and are shifting their portfolios toward lower-margin products. Given the cautious mood of investors, as well as the challenge of generating performance fees in falling markets, asset managers might face a difficult year.[2]

2. For more information, see the BCG report *The Growth Dilemma: Global Asset Management 2007.*

Exhibit 5. Only One Segment, Asset Managers, Had a Positive TSR in 2007



1. TSR comprises capital gains and free-cash-flow yields. 2. Only includes independent asset managers.
Note: All TSRs were calculated after conversion to U.S. dollars.
Sources: T.F. Datastream; BCG analysis.

Performance by Market Capitalization

The loss of market capitalization was most evident among the world's ten largest banks. In 2006, three top-ten banks had market capitalizations well above $200 billion. In 2007, only one bank—China's ICBC—reached such heights, with a market capitalization of nearly $340 billion, up from about $250 billion in 2006. The market capitalizations of the three largest Chinese banks increased by 32 percent in 2007 and accounted for 42 percent of the total market capitalization of the top ten. The size of the other banks in the top ten declined by almost 20 percent. The net effect was a 4 percent drop in the total market capitalization of the ten largest banks.

The shake-up among the top ten banks was the biggest since BCG began its annual studies of value creation in banking, in 2003. The three Chinese banks in the top ten—ICBC, China Construction Bank, and Bank of China—all gained ground and claimed three of the top four places in 2007. (See Exhibit 7.) The market capitalization of China's banking industry, as a whole, increased by 79 percent. Each of these three banks had both high net profits and low cost-to-income ratios, and their PE multiples ranged between 25 and 35, compared to an average of 13.6 for the global banking industry.

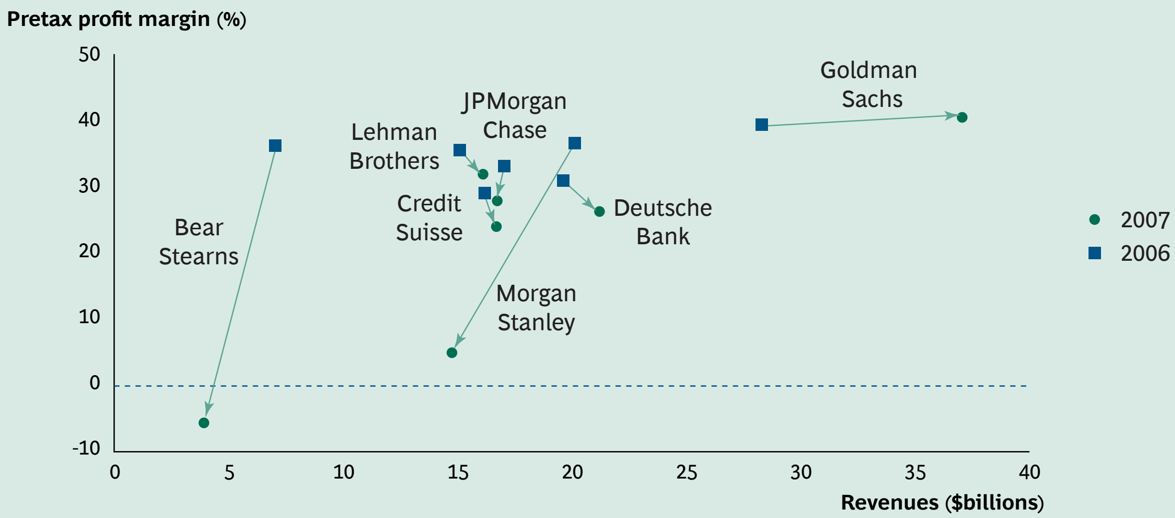
In contrast, the three largest U.S. banks—Citigroup, Bank of America, and JPMorgan Chase—lost ground. Citigroup fell furthest among the top ten. It moved from first place to sixth, while the other two banks each fell two places in the ranking.

Two new entrants in the top ten each got a boost from acquisitions. In 2006, UniCredit was the fifteenth-largest bank, by market capitalization. Its acquisition of Capitalia, in October 2007, made it one of the biggest banks in Europe. Banco Santander became one of the largest players in Brazil when it acquired ABN AMRO's local subsidiary, Banco Real, also in October 2007. The acquisition moved the bank from twelfth to eighth place in terms of market capitalization.

Other notable movements among the top 30 banks involved Sberbank and Barclays Bank, both of which moved 12 places. The former gained ground, while the latter fell.

Exhibit 6. Goldman Sachs Was the Only Leading Investment Bank that Increased Its Profit Margin and Revenues in 2007

Pretax profit margins and revenues of leading investment banks, 2007 versus 2006



Note: Does not take into account developments after December 31, 2007.
Sources: Company reports; BCG analysis.

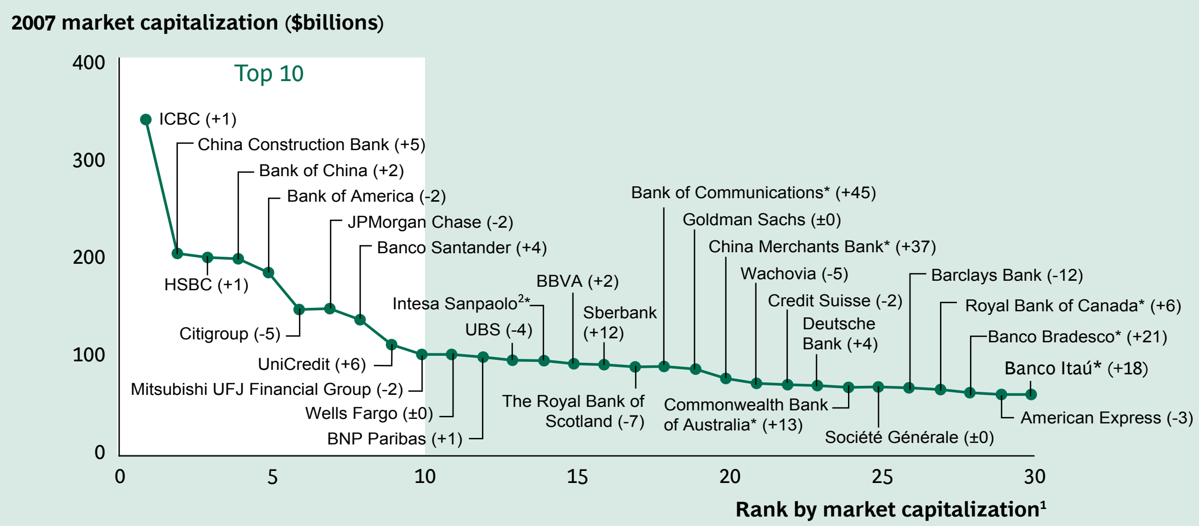
Sberbank, the eleventh-largest bank in Europe, benefited from Russia's growing consumer market and the broader economic expansion generated by rising oil prices. Its market capitalization increased by 39 percent in 2007, to $91.1 billion. Barclays Bank suffered losses due to its exposure to the subprime crisis.

Seven banks dropped out of the top 30. Three of these banks were in the United States: Merrill Lynch, Morgan Stanley, and U.S. Bancorp. Merrill Lynch and Morgan Stanley reported some of the largest write-downs associated with the subprime crisis, while U.S. Bancorp had already moved toward the bottom of the top 30 in 2006. Two U.K. banks dropped from the top 30: HBOS and Lloyds TSB. The other two banks that fell from the ranking were Japanese: Mizuho Financial Group and Sumitomo Mitsui Financial Group. The former faces losses from its leveraged-buyout financing operations in Europe, as well as from subprime-related write-downs. Sumitomo Mitsui Financial Group was affected by a declining expectation premium, losses in its consumer-finance business, and falling stock markets.

Four new entrants in the top 30 were from BRIC countries. Bank of Communications was first listed in 2005 in Hong Kong and became listed in Shanghai in 2007. It more than doubled its market capitalization last year, largely because of newly issued A-shares. China Merchants Bank entered the top 30 by substantially increasing net profit through a combination of rapid growth and effective cost controls.

Banco Bradesco and Banco Itaú are Brazil's largest and second-largest private-sector banks, respectively. Banco Bradesco is particularly strong in bancassurance. Its retail-banking efforts focus on the country's low- and medium-income customers. As with most large Brazilian banks, it has seen its profits grow tremendously due to a recent surge in consumer credit. Banco Itaú, which has grown through a mix of acquisitions and organic strategies—especially in domestic credit and retail operations—posted a record profit for a Brazilian bank. It nearly doubled its profit in 2007, to about $5 billion. (For more on emerging markets, see the sidebar "The Continuing Growth of BRIC Banking.")

Exhibit 7. Three of the Four Largest Banks in the World, Measured by Market Capitalization, Were Chinese



1. Numbers in parentheses indicate change in rank from 2006; * represents a new entry. 2. Intesa Sanpaolo was created on January 1, 2007, through the merger of two leading Italian banking groups, Banca Intesa and Sanpaolo IMI.
Note: All market capitalizations are based on end-of-year figures in U.S. dollars as of December 31, 2007.
Sources: T.F. Datastream; BCG analysis.

The Continuing Growth of BRIC Banking

Even by the unique standards of emerging markets, which lend themselves to hyperbole, the growth of banking in BRIC countries has been astounding. Their share of global banking market capitalization almost quintupled in two years, from 4 percent in 2005 to 19 percent in 2007. (See the exhibit below.) Over the same period, North American banks were in retreat, with their market-cap share dropping 11 percentage points. Banks in Western Europe maintained their market-cap share, while those in the rest of the world lost three percentage points.

Some of the growth in BRIC banking can be attributed to the massive IPOs of ICBC and Bank of China in 2006. By the end of 2006, these two banks accounted for 5.4 percent of global market capitalization. In addition, the diminishing fortunes of banks that were closely tied to the subprime crisis boosted the BRIC banking sector's share of global market capitalization in 2007.

At the same time, strong fundamental performance also played a role in the growth of BRIC banking. Banking TSRs in all four countries remained well above the average, even though some—notably in Russia and China—fell from the exceptional highs achieved in 2006. India's banking sector had the highest TSR, at 88 percent. In addition, banks in BRIC countries achieved low cost-to-income ratios and above-average ROEs—more than 20 percent in Brazil and Russia—while growth expectations heightened investor valuations.

Banks in BRIC countries also benefited from strong revenue streams. In both China and India, the emergence of an immense middle class has helped increase retail banking activity, while robust economic growth has led to an expansion of credit and high accruals in net interest income. Rising household income and a deepening of credit markets are doing the same for banks' revenue streams in Brazil and Russia. Across the four countries, corporate investments and a steady inflow of foreign investments are spurring growth in fee and commission income.

As healthy as they are, banking revenue streams in BRIC countries are not the main driver of rising market capitalizations. BRIC banking sectors accounted for nearly one-fifth of global banking market capitalization but only 9 percent of the total banking revenue pool. Rather, the rising market values of banks in BRIC countries owe much to expectations of future growth. These banking sectors are indeed poised to continue growing both equity and value, for several reasons:

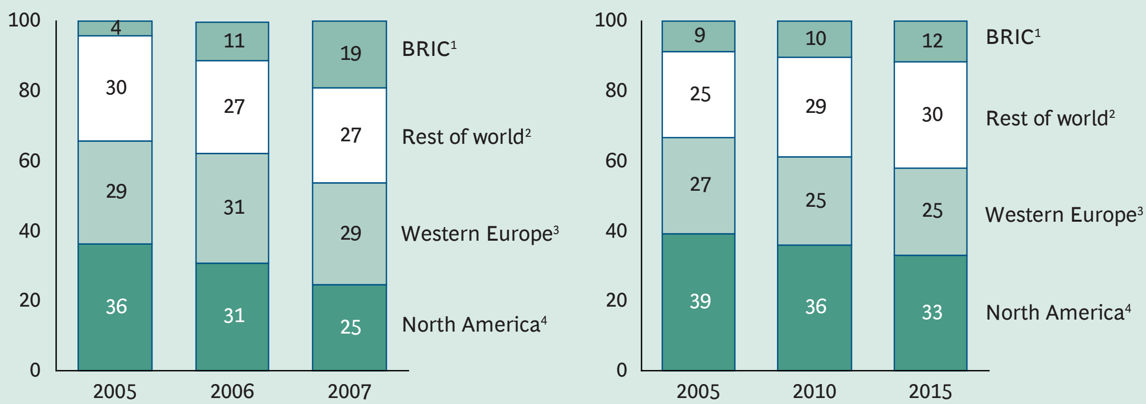
- **Economic growth is expected to continue at above-average rates.** From 2008 to 2012, real GDP is forecast to grow at an average annual rate of 9 percent in China, 7.5 percent in India, 5.3 percent in Russia, and 4.1 percent in Brazil.

- **Households have been increasing their wealth.** From 2001 to 2006, household wealth grew faster in China and Brazil than

BRIC Countries Significantly Increased Their Share of Global Banking Market Capitalization

Banking market capitalization, 2005–2007 (%)

Projected share of banking revenues, 2005–2015 (%)



1. Brazil, Russia, India, China. 2. Comprises 31 countries. 3. Benelux countries, Denmark, Finland, France, Germany, Italy, Norway, Spain, Sweden, Switzerland, United Kingdom.
4. United States and Canada.
Sources: T.F. Datastream; BCG analysis.

anywhere else in the world, at 23.4 percent and 22.4 percent, respectively.[1] Russia's wealth-management sector is nascent but is benefiting from a growing interest in onshore assets. A barometer of India's growing wealth is the success of HDFC, a mortgage bank that has profited from the country's swelling middle class.

- **Domestic and foreign investments are growing.** Deregulation will continue drawing foreign players, including banks, to Russia and China.[2] India has been attracting foreign investors, and a growing number of Western banks have been setting up subsidiaries.

The banking sectors in BRIC countries are playing an increasingly prominent role on the global banking stage. The emergence of global challengers is the most convincing sign of the vitality of BRIC banking. Three of the four largest banks in the world, by market capitalization, are Chinese. Eight of the top 30 banks are based in BRIC countries. A combination of low valuations and a weak U.S. dollar could kindle their interest in overseas targets. ICBC has already signaled its intention to expand abroad. Russia's Sberbank, which has had exceptional growth and performance, is looking for further opportunities in foreign markets.

1. For more on this subject, see the BCG report *Tapping Human Assets to Sustain Growth: Global Wealth 2007.*
2. For more information, see the BCG report *Banking on China: Successful Strategies for Foreign Entrants.*

BRIC countries seem to have set themselves apart from other emerging markets, but Indonesia and Turkey are making a strong case for inclusion in this exceptional group. Although Indonesia remains a relatively low-income country, it has a large and growing middle class, and household incomes are expected to continue rising. Both inflation and interest rates have fallen, and real GDP is expected to grow by 5.9 percent per year through 2012. Moreover, the country has come a long way since a banking crisis in the late 1990s. The crisis stimulated reforms that led to the liberalization and privatization of the banking sector. Indonesia is now considered to be one of the most open markets for foreign investors in Asia-Pacific. Foreign investments in domestic banks have grown steadily.

Turkey's increasingly stable economy has laid the groundwork for stronger banking and finance markets. The country's banking sector increased its market capitalization by almost 70 percent from 2006 to 2007. Banking revenues grew rapidly in 2007, driven mainly by consumer and corporate lending. In particular, the mortgage industry surged over the last few years and is projected to grow at an average rate of 20.1 percent per year from 2008 to 2011. In addition, foreign activity in the banking sector has increased substantially since 2001. Several banks have attracted large amounts of both portfolio and foreign direct investment.

Top-Performing Banks

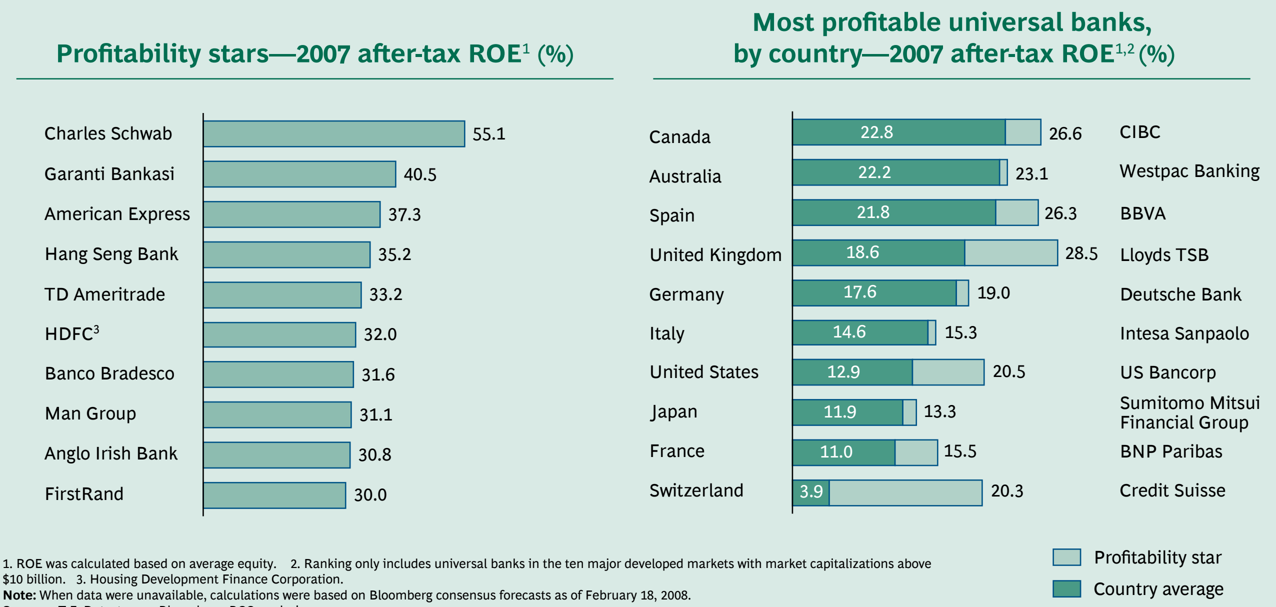
The average ROEs of profitability stars were exceptional, even by the standards of previous top performers. In 2007, the ten best ROEs ranged from 30 percent to 55.1 percent. In 2006, they had ranged from 23.9 percent to 35.5 percent. (See Exhibit 8.) Moreover, ten banks had ROEs of at least 30 percent in 2007, compared with just one in 2006.

Profitability stars: Europe and North America no longer dominate the ranking of top performers. Banks from emerging markets had some of the best ROEs. Garanti Bankasi, the third-largest private bank in Turkey, increased its interest income by 44 percent in 2007, mainly from loans, securities, and leasing businesses. Banco Bradesco grew its net income by 59 percent last year. Housing Development Finance Corporation (HDFC) was the first specialized mortgage company in India. Its net income increased by 40 percent in 2007, largely through interest income and the sale of investments. Hang Seng Bank, one of the largest banks in Hong Kong, increased its net profit by 43 percent in 2007, driven by wealth management and fee income.

However, a U.S. bank, Charles Schwab, topped the ROE ranking with an exceptional ROE of 55.1 percent. The performance of this bank was driven not only by its limited exposure to the crisis but also by a major restructuring effort that resulted in a leaner capital structure.

Profitable universal-banking sectors: among major developed markets, Canada had the strongest universal banks, measured by average ROE. Its best performer, CIBC, had an ROE of 26.6 percent. Universal-banking sectors in Australia and Spain rounded out the top three. Spain moved up from sixth place in 2006, while Australian universal banks continued their track record of strong performance, moving from third to second place. The countries that were home to the three best universal-banking sectors also had the three highest overall banking TSRs in 2007. In general, they were only marginally affected by the turmoil in the U.S. market. Having led the country rankings for three consecutive years, Switzerland's universal-

Exhibit 8. Several Emerging-Market Banks Were among the Most Profitable



1. ROE was calculated based on average equity. 2. Ranking only includes universal banks in the ten major developed markets with market capitalizations above $10 billion. 3. Housing Development Finance Corporation.
Note: When data were unavailable, calculations were based on Bloomberg consensus forecasts as of February 18, 2008.
Sources: T.F. Datastream; Bloomberg; BCG analysis.

banking sector fell to tenth place in 2007, mainly due to the performance of UBS.

Large-caps: the group of top performers, ranked by RTSR, was geographically diverse. Relative total shareholder return (RTSR) adjusts TSR for local market influences. The only U.S. players among the ten best RTSR performers from 2003 to 2007 were Goldman Sachs and Lehman Brothers. (See Exhibit 9.) Likewise, only two U.S. banks were among the ten best one-year RTSR performers: State Street and Bank of New York Mellon. Other top performers were from Australia, Europe, Japan, and emerging markets.

State Bank of India was the only large-cap bank in the top-ten RTSR rankings that had a negative alpha, indicating that its investors did not receive an adequate return for the risk they took. Alpha signifies individual risk-adjusted performance relative to the local market. If the value is positive, the stock is earning excess return, while a small or negative alpha indicates underperformance. (See the appendix for a description of RTSR and alpha.)

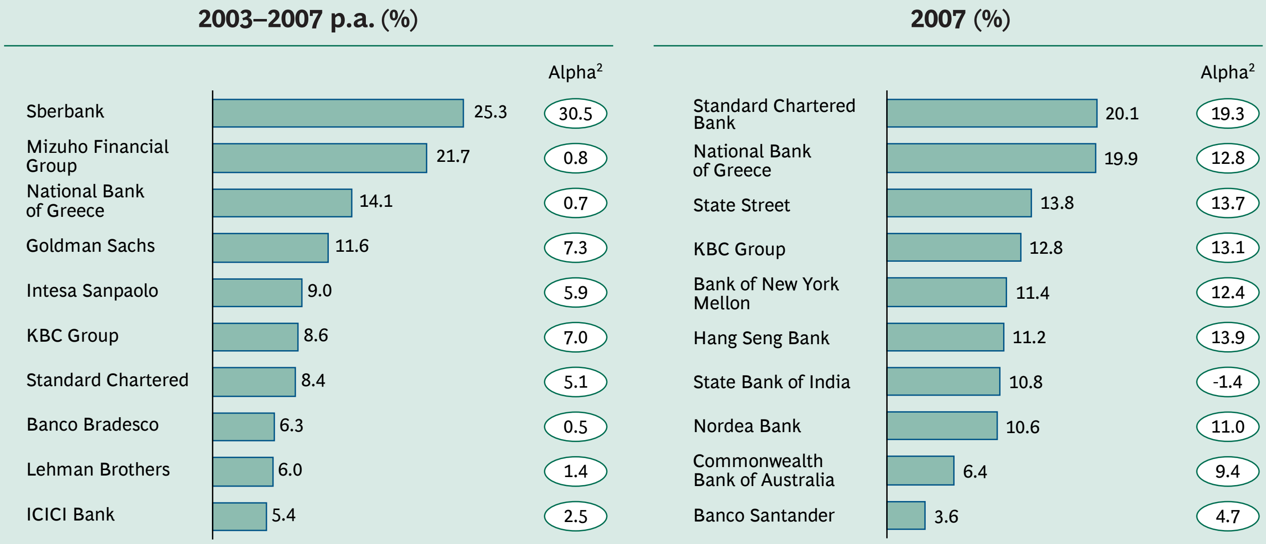
Sberbank topped the five-year RTSR ranking. Its profits for 2007 are expected to have increased by about 30 percent. Standard Chartered Bank had the highest one-year RTSR, driven by its outstanding performance in emerging markets. Although the bank is based in the United Kingdom, 90 percent of its profits came from Asia-Pacific, South Asia, the Middle East, and Africa. It also had the highest one-year alpha among large-cap banks, thanks to the combination of moderate underlying risk and a weak national market.

Mid-caps: asset managers were prevalent in the five-year RTSR ranking. T. Rowe Price Group, Man Group, and Franklin Templeton Investments claimed three of the top four places in the long-term RTSR ranking. (See Exhibit 10.) T. Rowe Price Group and Franklin Templeton Investments increased their assets under management by 19.5 percent and 26 percent, respectively. The five best long-term RTSR performers all had high alphas.

Two of the banks with strong five-year RTSRs had negative alphas. Macquarie Group's performance came against

Exhibit 9. Large-Cap Top Performers Came from Different Corners of the World

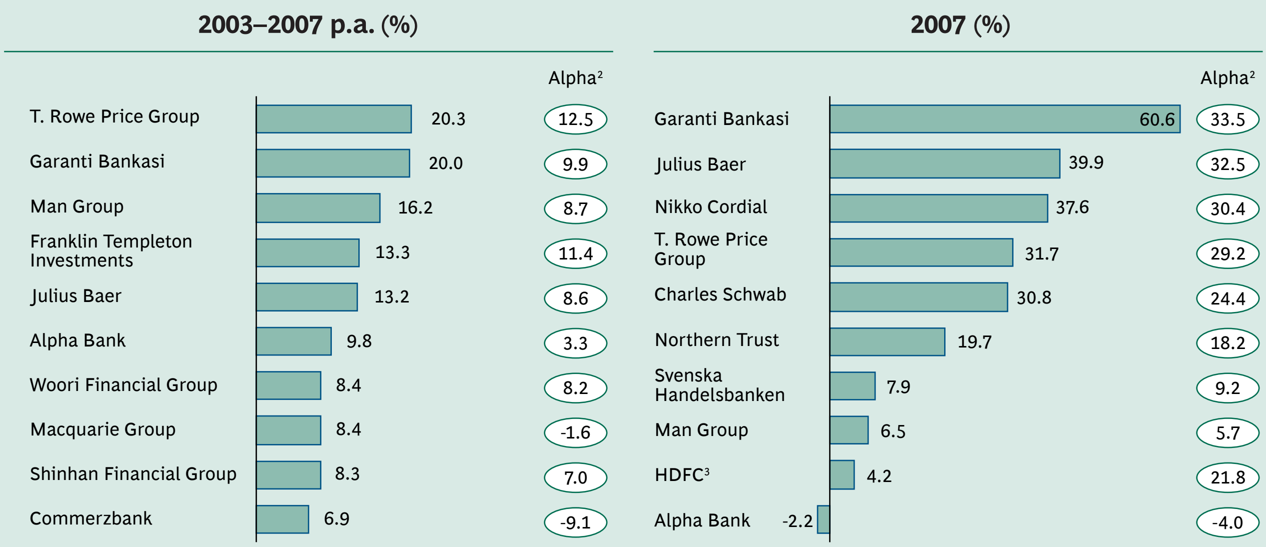
Top ten large-cap performers by RTSR[1]



1. Relative total shareholder return; for further explanation of this measure, see the appendix. 2. Alpha is the risk-adjusted excess return on an investment above what would be predicted by the market. For further explanation, see the appendix.
Note: The sample comprises the 50 largest banks by market capitalization as of December 31, 2007, in U.S. dollars, and with a five-year capital market history.
Sources: T.F. Datastream; BCG analysis.

Exhibit 10. Among Mid-Caps, Asset Managers Were Prevalent in the Ranking of Five-Year RTSR Top Performers

Top ten mid-cap performers by RTSR[1]



1. Relative total shareholder return; for further explanation of this measure, see the appendix. 2. Alpha is the risk-adjusted excess return on an investment above what would be predicted by the market. For further explanation, see the appendix 3. Housing Development Finance Corporation.
Note: The sample comprises the 51 to 100 largest banks by market capitalization as of December 31, 2007, in U.S. dollars, and with a five-year capital market history.
Sources: T.F. Datastream; BCG analysis.

the backdrop of a strong domestic market, and its stock was volatile. The same was true for Commerzbank: the German banking sector had the highest five-year TSR, and the bank's stock was volatile. Its performance was not commensurate with the risk.

Garanti Bankasi topped the one-year RTSR ranking, driven by an outstanding ROE of about 40 percent. Its high alpha shows that it significantly outperformed the Turkish stock market. Alpha Bank's negative alpha was due to both high volatility and a strong Greek stock market.

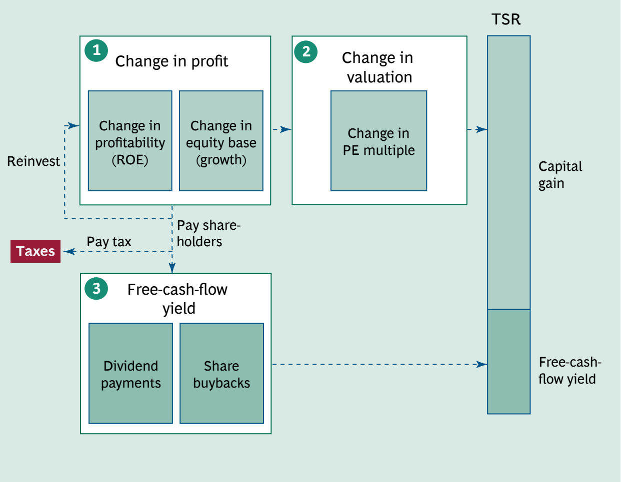
The one- and five-year RTSR rankings reflected broader trends in the global banking sector. The ten best large-cap performers were diversified and included several banks from emerging regions, while asset managers—which had only indirect exposure to the crisis—were prominent among the best mid-cap performers.

Understanding the Drivers of Value Creation

BCG's analysis of value creation quantifies the impact of three TSR drivers: profit growth, change in valuation, and free-cash-flow yield. Profit growth is determined by the change in a bank's profitability (measured as ROE) and equity base. A bank's valuation is a function of its PE multiple. Its free-cash-flow yield is a reflection of dividend payments and share buybacks.

Dissecting TSR into these discrete elements sheds light on the drivers that determine a bank's value-creation performance. (See Exhibit 11.)

Exhibit 11. TSR Can Be Decomposed into Three Main Drivers



Source: BCG analysis.

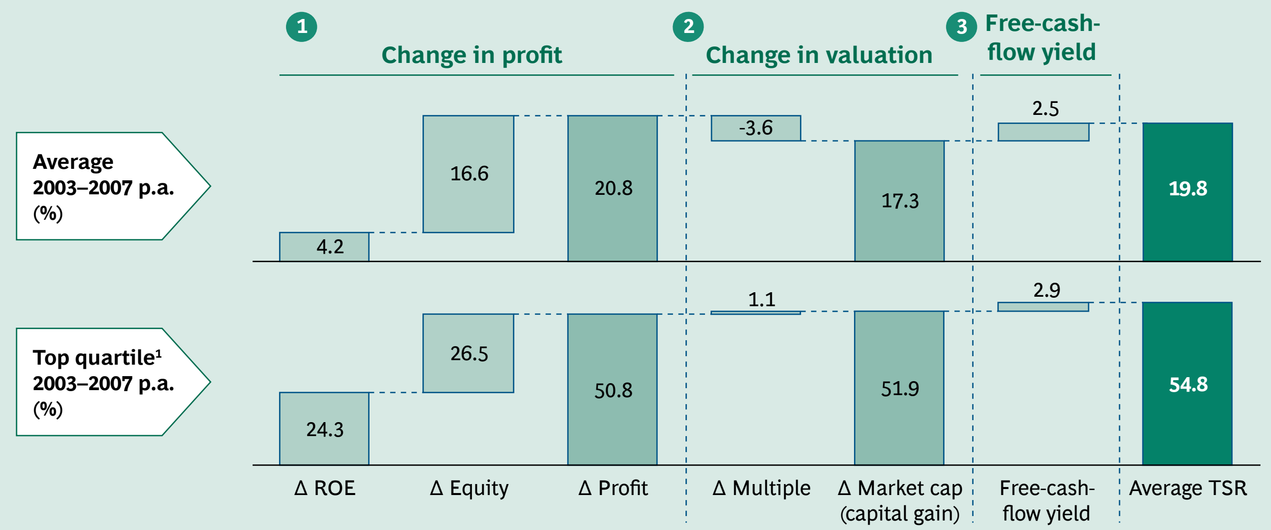
Five-Year Performance

Equity growth continued to make the greatest contribution to banks' TSR over the long term. Last year's report found that equity growth had accounted for the lion's share of long-term performance, and that its impact on TSR had been increasing. The story was the same in 2007, with equity growth making an even stronger contribution to five-year TSR. (See Exhibit 12.) Growth is a central theme in banking strategy, as evidenced by the rise of the "emerging titans" among the world's largest banks, the unprecedented shake-up of market-cap rankings, and the ongoing consolidation activities in banking sectors around the world. Growth, however, does not always translate directly into positive value creation; several banks with high rates of equity growth have had significant share dilutions and declines in PE multiples.

ROE improvement made only a small contribution to banks' five-year TSR. In 2007, banks' five-year ROE increased by only 4.2 percent and accounted for one-fifth of the overall change in profit. (In 2006, it had increased 7.1 percent and accounted for one-third of the overall change in profit.) Investor confidence remained the only negative driver of long-term TSR. Free-cash-flow yield made almost the same contribution to five-year TSR as it did in 2006.

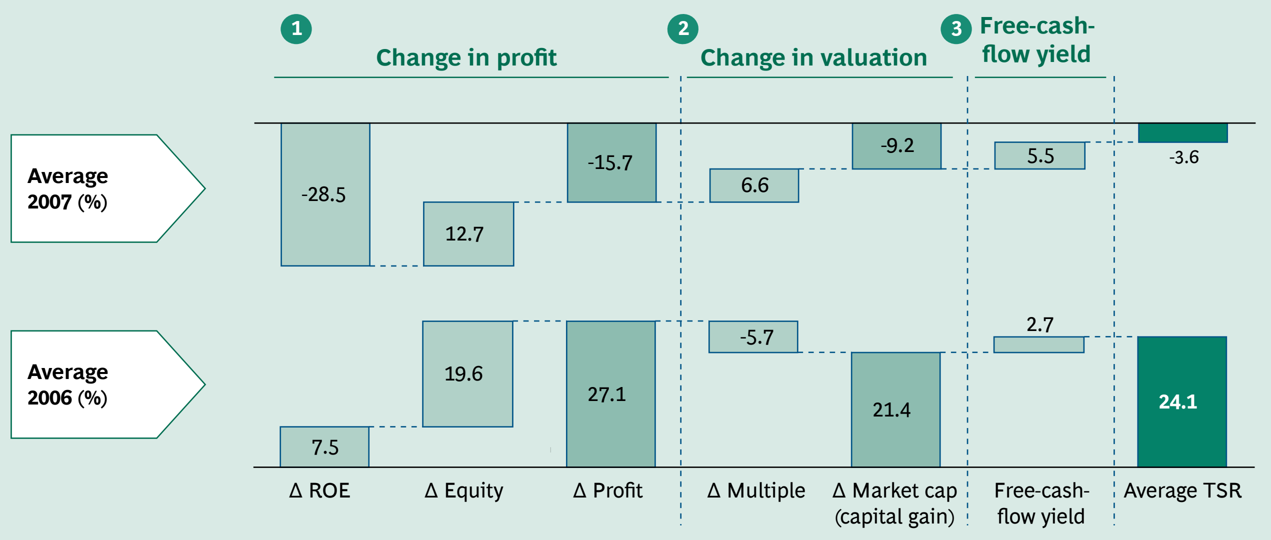
Improved profitability distinguished the top performers. Similar to the results of last year's study, top-quartile banks achieved better results across all three levers of five-year TSR. They increased their profits through a balanced mix of ROE and equity growth. Unlike in 2006, however, these top performers separated themselves from other banks mainly by increasing ROE well above the average.

Exhibit 12. Equity Growth Made the Greatest Contribution to Five-Year TSR



1. Top quartile was determined by a ranking of five-year TSR.
Notes: To meet the data requirements of the TSR analysis, a bank had to have a five-year capital market history. Calculations were therefore based on a subset of the total sample of banks. This subset represented nearly 70 percent of the industry's full market capitalization. When historical data were unavailable, calculations were based on Bloomberg consensus forecasts. Changes in drivers were based on precise, rather than rounded, figures.
Sources: T.F. Datastream; Bloomberg; BCG analysis.

Exhibit 13. A Sharp Fall in ROE Weighed Heavily on Banking TSR in 2007



Notes: To meet the data requirements of the TSR analysis, a bank had to have a five-year capital market history. Calculations were therefore based on a subset of the total sample of banks. When historical data were unavailable, calculations were based on Bloomberg consensus forecasts. Changes in drivers were based on precise, rather than rounded, figures.
Sources: T.F. Datastream; Bloomberg; BCG analysis.

Their change in ROE, at 24.3 percent, was nearly six times as high as the average. They also generated a positive change in their PE multiples, while the average PE multiple declined.

One-Year Performance

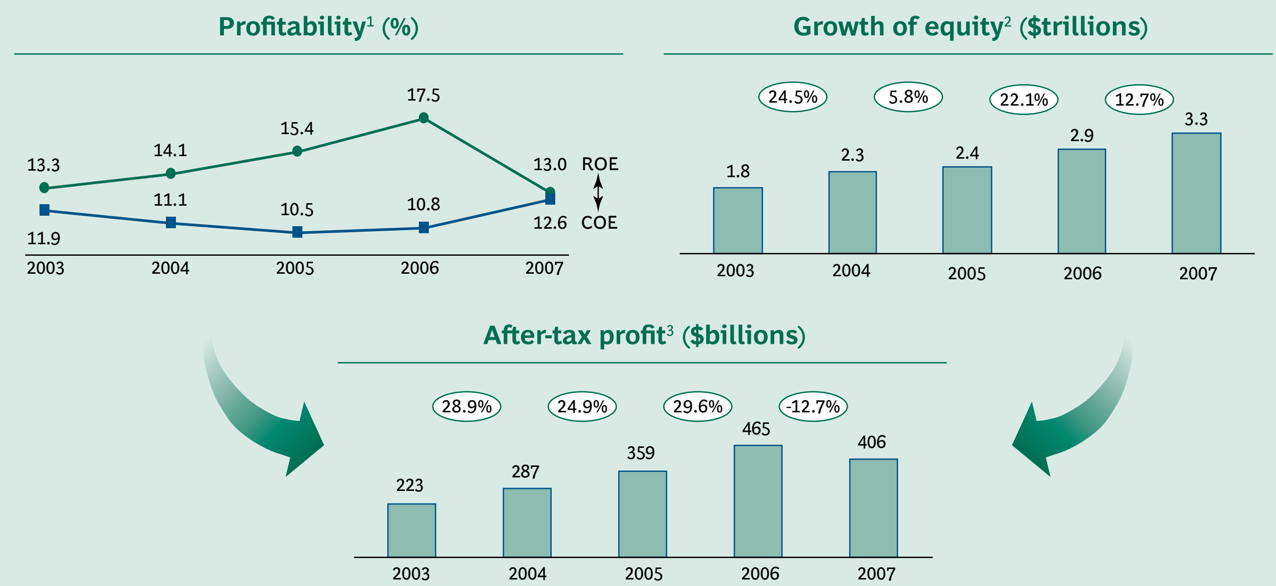
Banks' average TSR dropped by 27.7 percentage points in 2007, largely because of a steep decline in profitability. ROE plummeted by 28.5 percent in 2007. (See Exhibit 13.) Despite the challenging environment, this was the only negative value among the drivers of TSR. Equity growth weakened in 2007 but remained positive, at 12.7 percent. This was remarkable given the magnitude of write-downs and market-cap hits suffered by some of the largest banks. The net growth in equity provides further evidence that developed markets account for a decreasing proportion of the global banking industry—BRIC countries, in particular, have significantly grown their share of the world's total banking market capitalization.

The profit lever: the industry's steady run of rising profits came to an abrupt end. In 2007, the industry's ROE decreased 4.5 percentage points, to 13.0 percent, while its cost of equity (COE) grew 1.8 percentage points, to 12.6 percent. (See Exhibit 14.) The decrease in ROE can be attributed to the massive write-downs in Western banks, while the increase in COE was mainly driven by the high volatility of stocks, which reflects the riskier state of the industry. As a result, the profitability spread almost disappeared, falling from 6.7 to 0.4 percentage points. At the same time, the industry grew equity from $2.9 trillion to $3.3 trillion, thanks largely to growth in emerging markets. The net effect of a much narrower profitability spread and moderate growth in equity was a 12.7 percent decrease in after-tax profits, which fell for the first time since 2003, to $406 billion.

The valuation lever: investors were more optimistic. The average PE multiple increased to 13.6 in 2007. It had decreased each year from 2003 to 2006, when the industry was consistently posting high profits and strong growth. The increase came mainly from earnings having fallen further than prices. It could also be attributed to investors' belief that banks in emerging markets will continue to grow and perform well; that the crisis will be felt more in the near term than in the long term; and that banks will be compelled to restructure, cut costs, and refine their business strategies, all of which would eventually lead to stronger performance.

The free-cash-flow lever: the TSR contribution of share buybacks and dividend payouts doubled, to 5.5 percent. With the subprime crisis affecting liquidity and forcing banks to raise capital, some banks had no choice but to decrease both share buybacks and dividend payments. This suggests that other banks were able to increase their payouts considerably. Banks, in general, were more active in managing their free-cash-flow yields.

Exhibit 14. A Narrower Profitability Spread Led to a Decline in After-Tax Profit



1. ROE: after-tax return on average equity; COE: cost of equity. 2. Percentage changes are based on precise, rather than rounded, figures for changes in equity.
3. Percentage changes are based on precise, rather than rounded, figures for changes in after-tax profit.
Note: When historical data were unavailable for 2007, calculations were based on Bloomberg consensus forecasts.
Sources: T.F. Datastream; Bloomberg; BCG analysis.

Placing TSR at the Heart of Corporate Strategy

What is the right pathway to delivering superior TSR? Investors and executives at some of the world's largest banks have been wrestling with this question for years, yet the industry continues to face a range of vexing challenges—from low PE multiples to growth strategies that routinely fail to ignite TSR. The current crisis, which continues to deepen, has given banks an even greater sense of urgency to reexamine the way they develop their long-term strategies for delivering TSR.

In doing so, banks should emulate how leading companies—in financial services as well as in other sectors—aim to deliver superior TSR. These companies define explicit value-creation goals that integrate business strategies, financial policies, and investor considerations. To ensure strong TSR in a time of heightened insecurity, banks will need to follow a similarly holistic approach that addresses all three factors in their long-term corporate strategies.

The Challenge of Long-Term Value Creation in Banking

Several concerns are causing bank investors and executives to reassess the best strategy for creating value. While the short-term implications of these concerns may vary from bank to bank—based on their size, geographic scope, and business mix—over the long term they will affect the entire sector.

- **Low PE multiples.** PE multiples for many banks have declined to a level that creates an 8 to 12 percent yield if all earnings are paid out to investors as dividends. If these PE multiples persist, they will encourage banks to become cash-payout machines rather than innovators or growth engines. At the same time, however, low PE multiples will spur further consolidation, as they make banking assets or franchises look cheap by historical standards. Given the potential yields from dividends and buybacks, investors will demand a higher proof of value creation from banks' growth-oriented investments.

- **Sustainability of ROE.** With ROE levels so high—well above 30 percent for the top banks in our sample—banks can fund far more organic growth than demand for bank products and services can absorb. Many banks have recognized this imbalance and have stepped up their share repurchases to deploy excess earnings. This is a sensible short-term strategy, but many investors are concerned that banks will eventually be tempted to reinvest in unprofitable or higher-risk growth—both organic and M&A—that ends up eroding ROEs, thus undercutting genuine opportunities for profitable expansion or high cash payouts.

- **TSR-depleting growth.** Aggressive growth strategies have had a tendency to dampen TSR performance. In some cases, post-growth TSRs either did not match the returns that could have been generated by paying out earnings as dividends, or they simply ran out of steam. Over the past ten years, some of the world's largest banks have pursued M&A strategies that delivered below-average TSRs; these included plans to expand globally, as well as focused strategies to move into particular business areas. Other large banks achieved average to slightly above-average TSRs through targeted roll-up strategies, buying and combining retail banks in closely related markets. But they are now being challenged by the need to extend these roll-ups out of their geographic footprints.

Few, if any, superior TSR performances can be credited to expansionary or roll-up M&A strategies. Banks that have been far less growth-oriented—such as those in Canada and Australia, which face geographic or regulatory constraints on growth—have delivered much higher TSRs compared with banks that grew aggressively over the last five- and ten-year periods.

- **Increasingly cautious investors.** BCG's extensive interviews with bank investors have found that value and income investors play a leading role in many banks. Few growth investors see banks as growth stocks, and instead take a stake in the banking sector simply to diversify their portfolios. As a result, most large banks are not expected to play the role of a true growth stock.

  Given the current financial crisis, growth funds will likely move their holdings out of higher-growth banks and instead favor banks that can provide either PE multiple upside or high yields. Similarly, value and income investors will be even more concerned about risky growth strategies and more vocal about cash payouts. How long this sentiment will last is unclear, but banks' ability to manage investor concerns will go a long way toward determining which banks deliver superior near-term TSR, and may even decide which ones remain independent.

These challenges have important implications for all banks as they plan their strategies for the next three to five years.

An Integrated Approach to Strategy Development

This is a time of abnormal and discontinuous opportunities, constraints, and potential threats. Against this challenging backdrop, banks cannot rely on incremental business-strategy thinking, nor can they afford to adopt a wait-and-see or defensive posture. Instead, they must forge a corporate strategy that focuses squarely on an explicit TSR goal and fuses three types of strategy:

- **Business strategy.** The crisis is simultaneously expanding and narrowing business strategy choices concerning growth agendas, M&A opportunities, and the evolution of the portfolio mix. And it is doing so in different ways for different banks.

- **Financial strategy.** The crisis is reshaping financial strategy opportunities, constraints, and priorities. Banks will need to rethink their cash payout strategies, optimal capital ratios, and the use of equity currency for M&A activity.

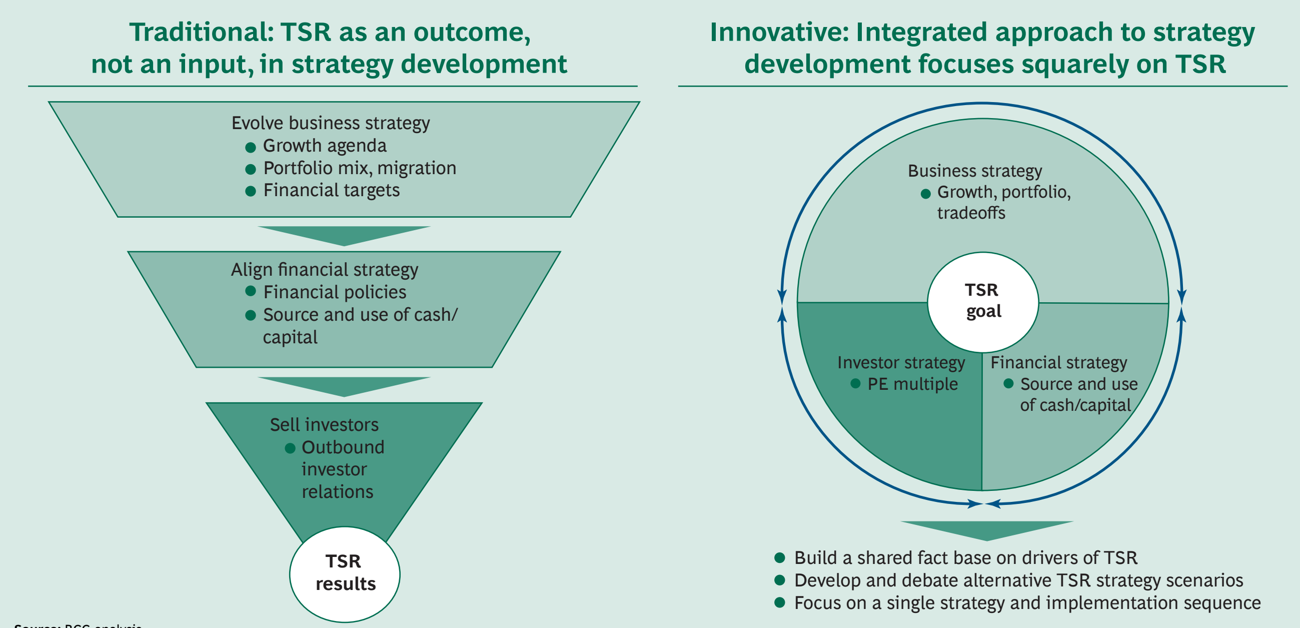
- **Investor strategy.** Investor strategy is paramount in the current environment. It is critical to boosting PE multiples and gaining solid investor support for management's strategy.

How does such an integrated approach differ from the norm? In most banks, strategy development follows a top-down approach. (See Exhibit 15.) Everything flows from management's vision for business strategy, which might encompass a growth agenda or an ideal portfolio mix. The bank's financial strategy, investor strategy, and TSR performance are all viewed as outcomes of the business strategy, rather than inputs.

Unfortunately, a bank's business strategy perspective, on its own, will rarely guarantee superior TSR results. The best-laid business strategies can be supported by suboptimal financial strategies and are always subject to the interpretation of capital markets. Investors may have a different take on the value-creation potential of the bank's business strategy and may react negatively to the financial strategy. In the end, they will have the last word on the strategy's impact on TSR.

The alternative to banks' traditional approach redefines the "center of the universe" for strategy development. It uses a TSR goal rather than a business strategy vision as the main driver of management thinking. This reordering of priorities underscores the notion that superior TSR—not market-cap size, market share, growth, or a particular portfolio mix—should be the bank's main goal. And it rec-

Exhibit 15. Banks Should Place TSR at the Center of Strategy Development



Source: BCG analysis.

ognizes that business strategy choices need to be informed by financial and investor strategy at the outset—not after a business strategy has been decided upon.

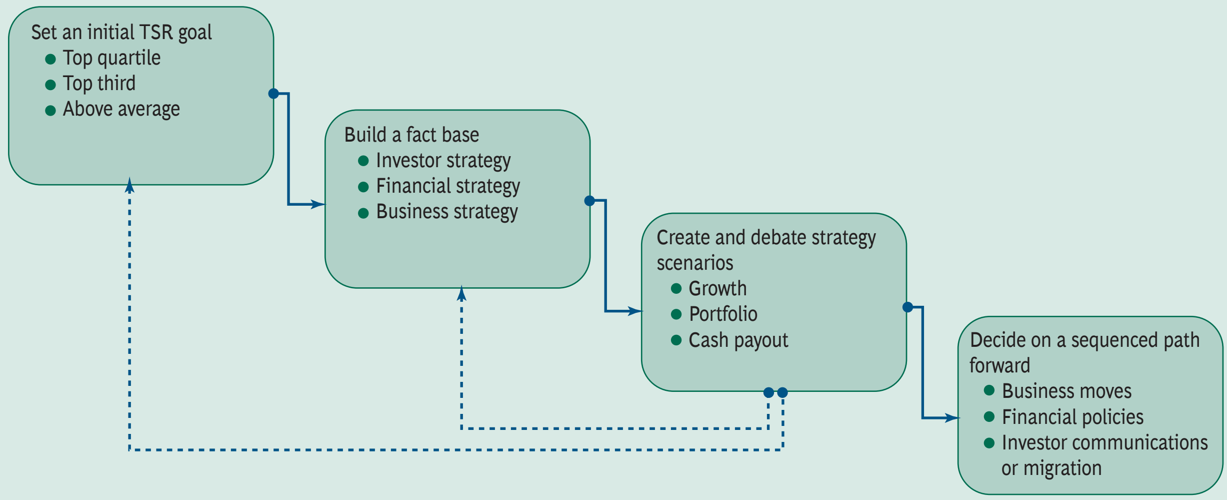
Developing an Integrated Strategy to Achieve Superior TSR

Four steps are essential to developing an integrated value-creation strategy. (See Exhibit 16.) In our experience, banks that follow these steps are often surprised by what they find—a disconnect between business strategies and TSR goals, for example—as well as by the control they gain over their value-creation destiny.

Step one: facilitate an open, honest discussion about the bank's TSR goals. This is critical for three reasons. First, it begins the process of rallying the management team around a common purpose. Second, it places TSR squarely at the center of the planning process. Third, it reveals how well the executive team understands the most important drivers of TSR for the bank. To make the most of these discussions, banks should:

- **Engage the right mix of executives.** The discussion group should be small—perhaps five to seven individuals—but should represent a range of perspectives.
- **Provide historical and prospective facts about TSR to the discussion group.** Based on analysts' forecasts, what is an expected average TSR? What does it take to be a top-quartile bank over a three- or five-year period? How do the drivers of TSR vary over time?
- **Forge agreement on both the time frame for achieving the target TSR and the bank's relevant peer group.** Value-creation strategies are often undermined by a lack of consensus on short- versus long-term priorities and tradeoffs. Selecting the right peer group will shape how a company thinks about its portfolio mix and strategy for the future.
- **Ensure that the discussion is open and honest.** The group should not work toward a preordained conclusion. Its purpose is to survey a variety of opinions that will shape the facts that need to be gathered and as-

Exhibit 16. The Four-Step Process for Developing an Integrated Strategy Begins with an Explicit TSR Goal



Source: BCG analysis.

sessed, as well as the range of TSR strategy scenarios to be explored in later steps.

This discussion group will not necessarily commit the bank to a final goal. In our experience, few companies end up where they started. After further analysis, they tend to move away from their initial beliefs about the right TSR goal or the priorities for achieving it.

Step two: develop a comprehensive fact base on the drivers of TSR. The discussion group will, in all likelihood, reveal a wide range of views about the factors that drive TSR. Many executives and even board members have different opinions about how to improve performance. They cannot all be correct. Six questions will help pinpoint the real drivers of TSR for a bank:

1. What are the drivers of the PE multiple in our peer group?

2. Who owns our stock, and what are their priorities and expectations?

3. How does M&A or divestiture affect TSR?

4. How do financial policies affect TSR?

5. What is the implied TSR of our company plan?

6. How does each business unit contribute to that TSR?

Answering the first four questions will provide a capital-markets-behavior perspective on the key drivers of TSR. (BCG has an extensive library of research on these topics.) The answers may not be obvious. The sophistication, behavior, and priorities of capital markets are constantly evolving. Only by developing an up-to-date fact base on these topics can executive teams ensure that their views are fully informed and nuanced enough to make the best decisions about how to prioritize and pull the right TSR levers.

The answers to the first four questions will help banks address the last two questions. A frank assessment of the impact on TSR of the company's plan often results in one

Strategic Pricing: A Lever to Improve TSR

Pricing is a fulcrum of competitive strategy. In the 1970s, BCG established a set of rules for strategic pricing. These rules seem especially relevant given the state of the banking industry. They are based on the principle that a company should price its products and services at a level that creates shareholder value. If a company has scale- or experience-driven economics, then pricing below cost—as a short-term tactic—can lead to competitive advantage and a higher return on capital. If, however, a company lacks scale- or experience-driven economics, pricing below cost is likely to undermine shareholder value.

Financial services investors are discerning when it comes to strategic pricing. They value one dollar of profit differently from another dollar, based largely on the predictability and scalability of a bank's earnings—two factors that make strategic pricing relatively easy. Profits from scalable, predictable transaction networks—like those run by credit-card-processing companies—have been rewarded with PE multiples as high as 25. (See the exhibit below.) By comparison, profits from high-risk, low-scale activities have PE multiples below 7. This group includes "commodity" lenders, which sell standardized loans. Some of these lenders have substantially underpriced risk.

This formula has created a wide disparity in the valuation of banking profits. A dollar of profit generated by a pure-play processor, for example, creates four times as much value as a dollar of profit generated by a credit-card lender. Although both players participate in the credit-card business, the former has a scalable cost structure and has been pricing above total costs, including capital costs, while the latter has not.

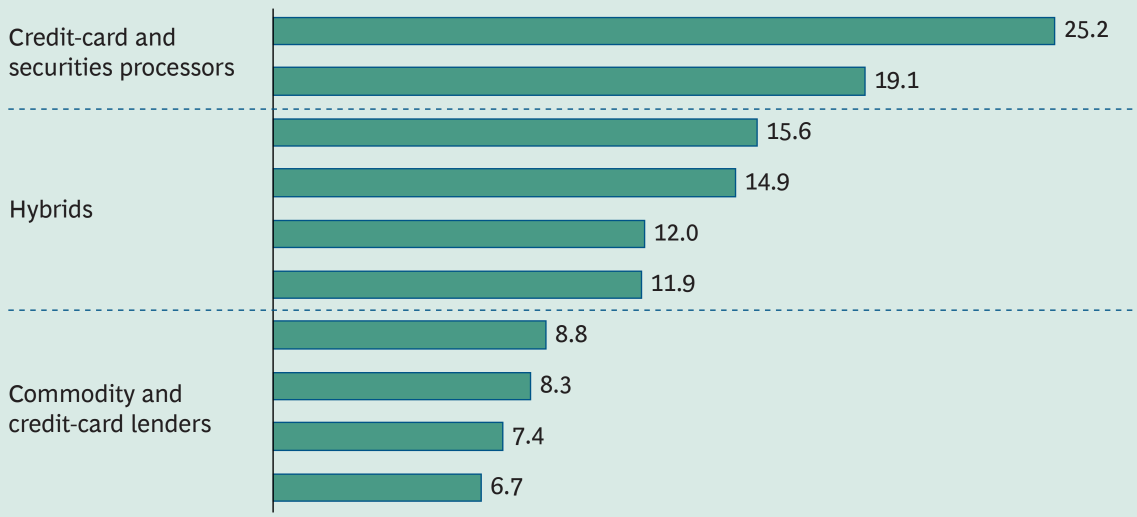
Historically, lenders have had low scalability and have been valued at around 12 times earnings or less. By comparison, the average PE multiple of the S&P 500 is 15. The recent practice of pricing below risk-adjusted costs appears to have caused the PE multiples of some lenders to fall even further. Hybrids of lenders and processors have been valued somewhere between the two. They have less perceived risk than lenders but lack the overall scalability of processors.

At a time when banks need to pull every lever for creating value, they cannot afford to overlook the relationship between the source of their profits and their PE multiples. Strategic pricing is critical in all banking segments, and scalability and predictability are, in turn, critical to strategic pricing.

Many banks have untapped sources of scale economies: for example, they could focus on delivering their services as efficiently as retailers do. They need to find ways to take advantage of such opportunities throughout their distribution networks. Wherever sustainable competitive advantage cannot be established, banks must ensure that their prices cover all risks and capital costs. Any damage to ROE from lost volumes will be compensated, in the long run, by higher valuations.

Forward PE Multiples Vary Widely

Forward PE multiples for a sample of U.S. financial services companies[1]



1. PE multiples based on prices as of January 16, 2008, and Zacks fiscal year 2008 consensus estimates.
Sources: Zacks; BCG analysis.

of three realizations. A common outcome is that the plan—on paper—creates a high TSR but is not achievable. Most three-to-five-year plans are more visionary than practical. A second possible outcome is that the plan's projected TSR is below executives' aspirations. A third is that the plan delivers a good TSR but lacks balance. Most of the value is created in the first year, for example, while TSR in subsequent years is weak.

Banks can bridge much of the gap between their TSR plans and aspirations by paying more attention to capital-markets considerations, such as investor mix, financial strategies, M&A initiatives, and the drivers of the PE multiple. (For more on the PE multiple, see the sidebar "Strategic Pricing: A Lever to Improve TSR.")

In general, however, even more value can be generated by assessing the contributions of the business units to TSR. Many banks use ROE to gauge the performance of business units, but different businesses can have different PE multiples, which could influence how banks allocate resources. Banks should instead examine business unit roles, priorities, and resource allocations, as well as the overall portfolio mix.

Often the insights that emerge from this perspective differ from those that are based on traditional metrics—for example, ROE, ROTE, RORAC, or economic profit—and will lead to a better allocation of resources, a clearer definition of business unit roles in driving TSR, and more appropriate short- and long-term targets for each business unit.

Step three: develop and debate a range of integrated TSR strategies. The perspectives developed in step one combined with the insights from step two will typically lead to three to five paths for achieving strong TSR. Each path will have different priorities and tradeoffs across business-strategy initiatives, financial-policy opportunities or constraints, and investor-strategy issues. They will also vary in their levels of risk and TSR outcomes, their short- and long-term results, their requirements for implementation, and their suitable investor mix.

As much as these strategies may diverge, they will share a common basis: the alignment of internal beliefs, comprehensive facts, and a goal of delivering superior TSR. In many banks, this will come as a refreshing change. Banks' value-creation plans are often undercut by internal tensions or competing views among corporate executives, line managers, and board members.

Step four: rally around an agreed-upon strategy and sequence it for maximum impact. Consistently delivering superior TSR is a difficult challenge; there are no simple and immutable prescriptions for doing so. Indeed, the best TSR strategies evolve over a three-to-five-year period. They may emphasize cash payouts or ROE improvements in the first two years but migrate toward higher growth in later years—or vice versa.

In general, an integrated value-creation strategy will put banks in a much better position to achieve strong TSR. Banks usually find that they have greater control over their value-creation destiny once they stop looking at TSR as a byproduct of business strategy.

Rankings of Top Performers

Rankings were performed by assessing all the banks for which a five-year RTSR could be calculated. Therefore, banks with public offerings after January 1, 2003, were excluded from this analysis; excluded banks include, for example, ICBC and Bank of China. Banks were then ranked by market capitalization and segmented into two groups: the largest 50 banking companies were designated "large-cap," and the companies ranked 51 to 100 were designated "mid-cap."

Large-Cap Banking Companies

RTSR rank		Company				Performance 2003–2007						
2003–2007	2007	Name	Country	Seg-ment	M' cap '07 ($billions)	RTSR p.a.	TSR	Market	Alpha p.a.	Risk	TSR p.a.	Rank
1	13	Sberbank	RUS	UB	91.1	25.3%	++++	+++	30.5%	+	87.0%	1
2	43	Mizuho Financial Group	JPN	UB	54.5	21.7%	++++	+	0.8%	- - - -	39.3%	6
3	2	National Bank of Greece	GRC	UB	32.6	14.1%	++++	+++	0.7%	- -	53.3%	5
4	14	The Goldman Sachs Group	USA	IB	85.5	11.6%	++++	+	7.3%	- -	27.0%	16
5	11	Intesa Sanpaolo	ITA	UB	93.7	9.0%	++++	++	5.9%	-	34.6%	10
6	4	KBC Group	BEL	UB	49.9	8.6%	++++	++	7.0%	-	38.1%	7
7	1	Standard Chartered Bank	GBR	UB	51.7	8.4%	++++	++	5.1%	-	30.6%	12
8	33	Banco Bradesco	BRA	UB	61.6	6.3%	++++	++++	0.5%	-	75.2%	2
9	34	Lehman Brothers	USA	IB	34.7	6.0%	++++	+	1.4%	- -	20.6%	25
10	32	ICICI Bank	IND	UB	34.8	5.4%	++++	++++	2.5%	-	64.5%	3
11	36	Sumitomo Mitsui Financial Group	JPN	UB	57.9	4.8%	++++	+	-8.4%	- - - -	20.0%	28
12	8	Nordea	SWE	UB	43.4	4.6%	++++	++	3.4%	-	35.9%	8
13	7	State Bank of India	IND	UB	31.7	3.9%	++++	++++	4.7%	+	62.2%	4
14	29	Credit Suisse Group	CHE	UB	69.9	3.3%	++++	++	-12.6%	- - -	25.1%	22
15	3	State Street	USA	AM	31.4	3.2%	++++	+	3.4%	+	17.4%	30
16	5	The Bank of New York Mellon	USA	AM	55.5	2.8%	++++	+	1.4%	-	16.9%	33
17	22	JPMorgan Chase	USA	UB	146.6	2.7%	++++	+	0.3%	- -	16.9%	34
18	9	Commonwealth Bank of Australia	AUS	UB	68.2	2.5%	++++	+++	4.3%	+	34.9%	9
19	12	Westpac Banking Corporation	AUS	UB	46.0	0.2%	++++	+++	-0.8%	-	31.9%	11
20	21	BNP Paribas	FRA	UB	98.2	0.0%	++++	++	1.9%	+	26.5%	20
21	16	The Toronto-Dominion Bank	CAN	UB	50.6	-0.1%	++++	++	6.9%	++	30.4%	13
22	24	U.S. Bancorp	USA	UB	54.8	-0.5%	+++	+	0.3%	+	13.2%	38
23	37	Société Générale	FRA	UB	67.4	-0.6%	++++	++	-6.2%	- -	25.7%	21
24	18	The Bank of Nova Scotia	CAN	UB	50.1	-0.9%	++++	++	7.3%	++	29.3%	15
25	10	Banco Santander	ESP	UB	135.2	-1.1%	++++	++	-6.6%	- -	29.9%	14
26	30	American Express	USA	CF	60.8	-1.6%	+++	+	-3.5%	-	11.9%	40
27	39	Morgan Stanley	USA	IB	56.4	-1.6%	+++	+	-4.1%	- -	11.9%	41
28	31	Mitsubishi UFJ Financial Group	JPN	UB	101.8	-2.0%	+++	+	-12.4%	- - -	12.2%	39
29	17	UniCredit	ITA	UB	110.8	-2.4%	++++	++	1.4%	++	20.5%	26
30	35	Deutsche Bank	DEU	UB	68.7	-2.6%	++++	++	-9.0%	- -	26.6%	19
31	25	Royal Bank of Canada	CAN	UB	65.6	-2.8%	++++	++	4.4%	++	26.8%	17
32	41	Crédit Agricole	FRA	UB	56.3	-3.0%	++++	++	-3.2%	-	22.7%	24
33	42	UBS	CHE	UB	96.0	-3.3%	++++	++	-10.7%	- -	17.1%	32
34	15	Nomura Holdings	JPN	IB	33.3	-3.6%	+++	+	-10.1%	- -	10.5%	43
35	23	Australia and New Zealand Banking Group	AUS	UB	46.3	-3.6%	++++	+++	-4.1%	-	26.7%	18
36	44	Barclays Bank	GBR	UB	66.3	-4.3%	++++	++	-4.2%	+	15.3%	35
37	49	Merrill Lynch	USA	IB	45.8	-4.5%	++	+	-12.0%	- - -	8.7%	44
38	28	Wells Fargo	USA	UB	101.3	-4.5%	++	+	-0.3%	+++	8.6%	45
39	38	Bank of America	USA	UB	183.1	-5.1%	++	+	-0.4%	+++	7.9%	46
40	19	BBVA	ESP	UB	91.8	-5.2%	++++	++	-8.0%	-	24.4%	23
41	20	HSBC Holdings	GBR	UB	198.3	-5.3%	+++	++	-2.3%	++	14.0%	36
42	26	Lloyds TSB Group	GBR	UB	53.1	-5.4%	+++	++	-9.5%	- -	13.9%	37
43	48	HBOS	GBR	UB	54.6	-7.3%	+++	++	-7.0%	+	11.6%	42
44	6	Hang Seng Bank	HKG	UB	39.5	-7.5%	++++	++	1.4%	++	20.5%	27
45	40	Fortis	BEL	UB	57.3	-7.9%	++++	++	-13.1%	- -	17.1%	31
46	46	Wachovia	USA	UB	72.3	-7.9%	+	+	-8.4%	-	4.7%	48
47	27	National Australia Bank	AUS	UB	54.2	-9.6%	++++	+++	-8.9%	+	18.9%	29
48	45	The Royal Bank of Scotland	GBR	UB	88.5	-11.9%	++	++	-10.2%	+	6.2%	47
49	50	Citigroup	USA	UB	146.6	-12.0%	+	+	-14.5%	-	0.1%	49
50	47	Fannie Mae	USA	MF	39.1	-18.0%	- -	+	-22.0%	- -	-6.7%	50

Largest increase			
From ('02–'06)	To ('03–'07)	Positions gained	Company
45	16	29	The Bank of New York Mellon
41	14	27	Credit Suisse Group
38	15	23	State Street
25	3	22	National Bank of Greece
43	25	18	Banco Santander

Largest decline			
From ('02–'06)	To ('03–'07)	Positions lost	Company
8	46	38	Wachovia
10	39	29	Bank of America
16	37	21	Merrill Lynch
18	38	20	Wells Fargo
6	23	17	Société Générale

AM Asset managers
CF Consumer finance
IB Investment banks
MF Mortgage finance
UB Universal banks

RTSR: Relative total shareholder return
TSR: Total shareholder return — - - - - (++++) strongly negative (positive)
Risk: Volatility of returns compared to domestic market (β) — - - - - (++++) very high (low)
Market: Stock-specific impact of overall market — - - - - (++++) strongly negative (positive)

Mid-Cap Banking Companies

RTSR rank		Company				Performance 2003–2007						
2003–2007	2007	Name	Country	Segment	M' cap '07 ($billions)	RTSR p.a.	TSR	Market	Alpha p.a.	Risk	TSR p.a.	Rank
1	4	T. Rowe Price Group	USA	AM	16.1	20.3%	++++	+	12.5%	- - -	36.9%	14
2	1	Türkiye Garanti Bankasi	TUR	UB	18.8	20.0%	++++	+++	9.9%	- -	79.5%	1
3	8	Man Group	GBR	AM	19.4	16.2%	++++	++	8.7%	- -	40.0%	9
4	11	Franklin Templeton Investments	USA	AM	28.0	13.3%	++++	+	11.4%	-	28.9%	20
5	2	Julius Baer Group	CHE	IB	18.5	13.2%	++++	++	8.6%	- -	37.0%	13
6	10	Alpha Bank	GRC	UB	15.0	9.8%	++++	+++	3.3%	- -	47.6%	4
7	46	Woori Financial Group	KOR	UB	16.2	8.4%	++++	+++	8.2%	-	43.5%	5
8	27	Macquarie Group	AUS	IB	18.2	8.4%	++++	+++	-1.6%	- -	42.6%	7
9	28	Shinhan Financial Group	KOR	UB	22.6	8.3%	++++	+++	7.0%	-	43.3%	6
10	33	Commerzbank	DEU	UB	25.3	6.9%	++++	++	-9.1%	- - -	39.0%	11
11	13	OTP Bank	HUN	UB	14.2	6.5%	++++	+++	3.2%	-	41.3%	8
12	5	Charles Schwab	USA	IB	29.5	6.1%	++++	+	-4.6%	- - - -	20.7%	32
13	6	Northern Trust	USA	UB	16.8	4.5%	++++	+	4.2%	-	18.9%	39
14	3	Nikko Cordial Securities	JPN	IB	14.6	4.3%	++++	+	-2.4%	- - -	19.4%	36
15	12	EFG Eurobank Ergasias	GRC	UB	18.5	3.8%	++++	+++	-1.3%	-	39.5%	10
16	9	Housing Development Finance Corporation	IND	MF	20.5	3.6%	++++	++++	9.6%	+	61.7%	2
17	15	Standard Bank Group	ZAF	UB	20.1	2.9%	++++	+++	-2.3%	-	37.4%	12
18	30	Türkiye Iş Bankasi	TUR	UB	17.3	2.7%	++++	+++	-4.0%	-	53.6%	3
19	23	Mediobanca	ITA	UB	16.9	0.5%	++++	++	-1.1%	-	24.1%	26
20	26	FirstRand	ZAF	UB	16.3	0.4%	++++	+++	-4.4%	-	34.1%	17
21	24	PNC Financial Services Group	USA	UB	22.4	-0.3%	+++	+	3.2%	++	13.4%	44
22	31	SEB	SWE	UB	17.0	-0.3%	++++	++	-6.5%	- -	29.5%	19
23	20	Erste Bank	AUT	UB	22.4	-0.5%	++++	+++	-1.4%	-	35.3%	16
24	16	Bank Pekao	POL	UB	24.0	-1.1%	++++	+++	-2.2%	-	35.7%	15
25	40	Bank of China (Hong Kong)	HKG	UB	29.6	-1.5%	++++	++	-0.9%	+	28.3%	22
26	25	St.George Bank	AUS	UB	15.4	-2.3%	++++	+++	-2.9%	-	28.5%	21
27	35	Maybank	MYS	UB	13.6	-2.8%	++++	++	2.8%	++	20.6%	35
28	48	Natixis	FRA	UB	23.5	-3.3%	++++	++	-2.0%	+	22.3%	30
29	49	Capital One Services	USA	CF	19.8	-3.4%	++	+	-13.0%	- - -	9.9%	46
30	17	OCBC Bank	SGP	UB	18.0	-3.8%	++++	++	0.6%	+	25.7%	24
31	38	Suncorp-Metway	AUS	UB	13.8	-3.9%	++++	+++	-5.0%	-	26.5%	23
32	41	Banco Popolare	ITA	UB	14.2	-3.9%	++++	++	-6.2%	-	18.6%	40
33	45	CIBC	CAN	UB	23.9	-4.1%	++++	++	2.2%	++	25.2%	25
34	34	Swedbank	SWE	UB	14.6	-4.7%	++++	++	-5.6%	-	23.8%	28
35	7	Svenska Handelsbanken	SWE	UB	19.7	-5.0%	++++	++	-0.4%	++	23.5%	29
36	14	Allied Irish Banks	IRL	UB	20.2	-5.5%	++++	++	-2.3%	+	15.4%	43
37	39	Danske Bank	DNK	UB	27.4	-5.6%	++++	++	3.2%	++	23.9%	27
38	22	DnB NOR	NOR	UB	20.4	-5.8%	++++	+++	-2.1%	+	33.1%	18
39	36	DBS Group	SGP	UB	21.8	-6.7%	++++	++	-9.8%	-	21.9%	31
40	19	Dexia	BEL	UB	29.4	-6.8%	++++	++	-16.2%	- -	18.4%	41
41	37	Bank of Montreal	CAN	UB	28.5	-7.6%	++++	++	0.4%	++	20.6%	34
42	42	SunTrust Banks	USA	UB	21.8	-7.6%	++	+	-4.8%	++	5.1%	47
43	21	United Overseas Bank	SGP	UB	21.1	-7.6%	++++	++	-3.8%	+	20.7%	33
44	18	Banco Comercial Português	PRT	UB	15.4	-8.1%	++++	++	-21.4%	- -	19.3%	38
45	32	Bank of Ireland	IRL	UB	14.8	-8.4%	+++	++	-7.0%	+	11.9%	45
46	29	Grupo Banco Popular	ESP	UB	20.8	-9.1%	++++	++	-7.2%	+	19.3%	37
47	47	Regions Financial Corporation	USA	UB	16.4	-11.2%	+	+	-8.8%	++	1.0%	48
48	43	Kookmin Bank	KOR	UB	24.8	-11.3%	++++	+++	-13.4%	-	17.4%	42
49	44	BB&T	USA	UB	16.9	-12.1%	+	+	-9.5%	++	0.0%	49
50	50	Freddie Mac	USA	MF	23.6	-19.3%	- -	+	-24.8%	- -	-8.2%	50

Largest increase			
From ('02–'06)	To ('03–'07)	Positions gained	Company
46	13	33	Northern Trust
47	14	33	Nikko Cordial Securities
37	5	32	Julius Baer Group
41	12	29	Charles Schwab
39	18	21	Türkiye Iş Bankasi

Largest decline			
From ('02–'06)	To ('03–'07)	Positions lost	Company
18	41	23	Bank of Montreal
7	28	21	Natixis
11	32	21	Banco Popolare
13	34	21	Swedbank
28	47	19	Regions Financial Corporation

AM Asset managers
CF Consumer finance
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RTSR: Relative total shareholder return
TSR: Total shareholder return — - - - - (++++) strongly negative (positive)
Risk: Volatility of returns compared to domestic market (β) — - - - - (++++) very high (low)
Market: Stock-specific impact of overall market — - - - - (++++) strongly negative (positive)

Ranking by Segment

Segment	RTSR '03–'07		Company			TSR '03–'07	
	RTSR rank	RTSR p.a.	Name	Country	M' cap '07 ($billions)	Rank	TSR p.a.
Asset managers	1	20.3%	T. Rowe Price Group	USA	16.1	2	36.9%
	2	16.2%	Man Group	GBR	19.4	1	40.0%
	3	13.3%	Franklin Templeton Investments	USA	28.0	3	28.9%
	4	3.2%	State Street	USA	31.4	4	17.4%
	5	2.8%	The Bank of New York Mellon	USA	55.5	5	16.9%
Consumer finance	1	-1.6%	American Express	USA	60.8	1	11.9%
	2	-3.4%	Capital One Services	USA	19.8	3	9.9%
	3	-3.4%	Credit Saison	JPN	5.0	2	10.6%
	4	-20.0%	Sallie Mae	USA	8.3	4	-9.0%
	5	-24.2%	Takefuji Corporation	JPN	3.6	5	-13.2%
Investment banks	1	11.6%	The Goldman Sachs Group	USA	85.5	1	27.0%
	2	6.0%	Lehman Brothers	USA	34.7	2	20.6%
	3	-1.6%	Morgan Stanley	USA	56.4	3	11.9%
	4	-3.6%	Nomura Holdings	JPN	33.3	4	10.5%
	5	-4.5%	Merrill Lynch	USA	45.8	5	8.7%
Mortgage finance	1	20.4%	Home Capital Group	CAN	1.5	1	57.2%
	2	0.0%	Aareal Bank	DEU	1.9	2	30.0%
	3	-8.8%	Deutsche Hypothekenbank	DEU	0.7	3	18.6%
	4	-17.1%	Countrywide Financial Corporation	USA	5.2	4	-5.6%
	5	-25.0%	The PMI Group	USA	1.1	5	-14.6%
Universal banks	1	25.3%	Sberbank	RUS	91.1	1	87.0%
	2	9.0%	Intesa Sanpaolo	ITA	93.7	4	34.6%
	3	6.3%	Banco Bradesco	BRA	61.6	2	75.2%
	4	4.8%	Sumitomo Mitsui Financial Group	JPN	57.9	14	20.0%
	5	3.3%	Credit Suisse Group	CHE	69.9	10	25.1%
	6	2.7%	JPMorgan Chase	USA	146.6	17	16.9%
	7	2.5%	Commonwealth Bank of Australia	AUS	68.2	3	34.9%
	8	0.0%	BNP Paribas	FRA	98.2	8	26.5%
	9	-0.6%	Société Générale	FRA	67.4	9	25.7%
	10	-1.1%	Banco Santander	ESP	135.2	5	29.9%
	11	-2.0%	Mitsubishi UFJ Financial Group	JPN	101.8	20	12.2%
	12	-2.4%	UniCredit	ITA	110.8	13	20.5%
	13	-2.6%	Deutsche Bank	DEU	68.7	7	26.6%
	14	-2.8%	Royal Bank of Canada	CAN	65.6	6	26.8%
	15	-3.0%	Crédit Agricole	FRA	56.3	12	22.7%
	16	-3.3%	UBS	CHE	96.0	16	17.1%
	17	-4.3%	Barclays Bank	GBR	66.3	18	15.3%
	18	-4.5%	Wells Fargo	USA	101.3	21	8.6%
	19	-5.1%	Bank of America	USA	183.1	22	7.9%
	20	-5.2%	BBVA	ESP	91.8	11	24.4%
	21	-5.3%	HSBC Holdings	GBR	198.3	19	14.0%
	22	-7.9%	Fortis	BEL	57.3	15	17.1%
	23	-7.9%	Wachovia	USA	72.3	24	4.7%
	24	-11.9%	The Royal Bank of Scotland	GBR	88.5	23	6.2%
	25	-12.0%	Citigroup	USA	146.6	25	0.1%

RTSR: Relative total shareholder return
TSR: Total shareholder return

For each segment, the five largest banks, by market capitalization, are listed, except for universal banks, where the 25 largest banks are listed.

Ranking by Country

Country	Company			TSR '03–'07	
	Name	Segment	M' cap '07 ($billions)	Rank	TSR p.a.
Australia 	Macquarie Group	IB	18.2	1	42.6%
	Commonwealth Bank of Australia	UB	68.2	2	34.9%
	Westpac Banking Corporation	UB	46.0	3	31.9%
	Australia and New Zealand Banking Group	UB	46.3	4	26.7%
	National Australia Bank	UB	54.2	5	18.9%
Canada 	The Toronto-Dominion Bank	UB	50.6	1	30.4%
	The Bank of Nova Scotia	UB	50.1	2	29.3%
	Royal Bank of Canada	UB	65.6	3	26.8%
	CIBC	UB	23.9	4	25.2%
	Bank of Montreal	UB	28.5	5	20.6%
France 	Union Financière de France	AM	0.9	1	28.4%
	BNP Paribas	UB	98.2	2	26.5%
	Société Générale	UB	67.4	3	25.7%
	Crédit Agricole	UB	56.3	4	22.7%
	Natixis	UB	23.5	5	22.3%
Germany 	Commerzbank	UB	25.3	1	39.0%
	Landesbank Berlin	UB	9.3	2	35.0%
	Aareal Bank	MF	1.9	3	30.0%
	Deutsche Bank	UB	68.7	4	26.6%
	Oldenburgische Landesbank	UB	1.7	5	1.6%
Italy 	Intesa Sanpaolo	UB	93.7	1	34.6%
	Mediobanca	UB	16.9	2	24.1%
	Banca Monte dei Paschi di Siena	UB	13.2	3	21.4%
	UniCredit	UB	110.8	4	20.5%
	Banco Popolare	UB	14.2	5	18.6%
Japan 	Mizuho Financial Group	UB	54.5	1	39.3%
	Sumitomo Mitsui Financial Group	UB	57.9	2	20.0%
	Nikko Cordial Securities	IB	14.6	3	19.4%
	Mitsubishi UFJ Financial Group	UB	101.8	4	12.2%
	Nomura Holdings	IB	33.3	5	10.5%
Spain 	Bankinter	UB	7.3	1	33.0%
	Banco Santander	UB	135.2	2	29.9%
	Banco de Sabadell	UB	13.3	3	29.8%
	BBVA	UB	91.8	4	24.4%
	Grupo Banco Popular	UB	20.8	5	19.3%
Switzerland 	Banque Cantonale Vaudoise	UB	3.8	1	51.5%
	Julius Baer Group	IB	18.5	2	37.0%
	Vontobel Group	IB	3.1	3	29.7%
	Credit Suisse Group	UB	69.9	4	25.1%
	UBS	UB	96.0	5	17.1%
United Kingdom 	Barclays Bank	UB	66.3	1	15.3%
	HSBC Holdings	UB	198.3	2	14.0%
	Lloyds TSB Group	UB	53.1	3	13.9%
	HBOS	UB	54.6	4	11.6%
	The Royal Bank of Scotland	UB	88.5	5	6.2%
United States 	The Goldman Sachs Group	IB	85.5	1	27.0%
	Charles Schwab	IB	29.5	2	20.7%
	Lehman Brothers	IB	34.7	3	20.6%
	State Street	AM	31.4	4	17.4%
	The Bank of New York Mellon	AM	55.5	5	16.9%
	JPMorgan Chase	UB	146.6	6	16.9%
	U.S. Bancorp	UB	54.8	7	13.2%
	American Express	CF	60.8	8	11.9%
	Morgan Stanley	IB	56.4	9	11.9%
	Merrill Lynch	IB	45.8	10	8.7%
	Wells Fargo	UB	101.3	11	8.6%
	Bank of America	UB	183.1	12	7.9%
	Wachovia	UB	72.3	13	4.7%
	Citigroup	UB	146.6	14	0.1%
	Fannie Mae	MF	39.1	15	-6.7%

AM Asset managers IB Investment banks UB Universal banks
CF Consumer finance MF Mortgage finance

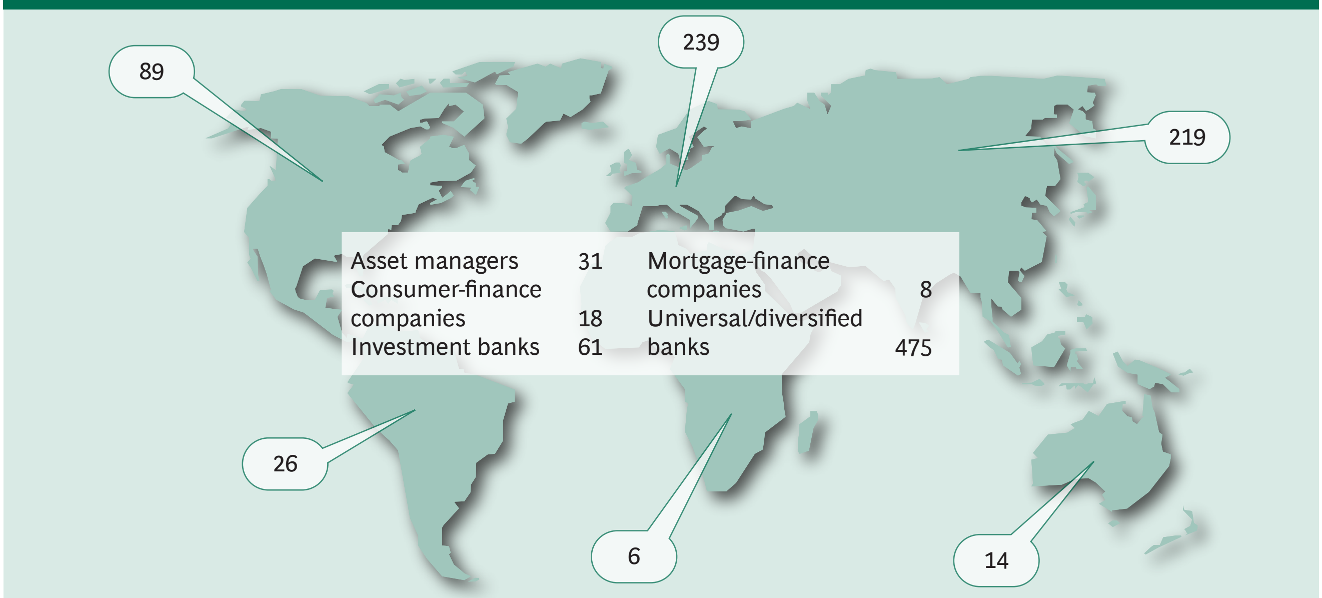
For each country, the five largest banks, by market capitalization, are listed, except for the United States, where the 15 largest banks are listed.

Appendix: Sample and Methodology

The analyses in this report are based on a sample of 593 stock-market-listed universal and specialized companies in the banking industry. The companies include all major banking players and represent more than 75 percent of the industry's total market capitalization as of January 2008. To meet the data requirements of the TSR analysis in the second chapter, we used a subset of the full market sample—388 banks instead of 593. This subset represents nearly 70 percent of the industry's total market capitalization.

Five segments are distinguished in the sample: universal and diversified banks with a broad business portfolio; investment banks (providers of capital markets services and corporate finance services); asset managers (providers of retail broker services and money management, including investments, budgeting, banking, and taxes); consumer-finance businesses (credit-card companies and providers of personal financial services); and mortgage-finance companies (providers of mortgages and mortgage insurance). Companies were categorized in these segments according to their dominant business focus.

The Sample Includes 593 Companies in Different Regions and Segments



Sources: T.F. Datastream; BCG analysis.

Most of the historical capital-market and fundamental data for the sample were acquired from Thomson Financial Datastream. Bloomberg consensus forecasts, if available, were used to fill gaps in data for 2007, with estimated data as of February 18, 2008.

Definitions and Methodology

Total shareholder return (TSR). TSR measures the change in a company's stock price and/or gains from reinvesting dividends paid in a particular period. It is the percentage change of the return index on a given stock. To measure the true capital-market performance of a company, TSR was adjusted for two elements: the impact of local stock-market performance and the impact of risk.

Relative total shareholder return (RTSR). Like TSR, RTSR measures shareholder returns based on capital gains and free-cash-flow yield, but it adjusts a company's TSR to account for the impact of the local stock market. This is important when drawing comparisons between companies in different countries. For example, one company's performance could be buoyed by a bull market while another company's performance could be dampened by a bear market.

Alpha. This measure adjusts a company's excess return for the volatility of stock relative to the local market. Alpha accounts for the expectation that companies that take on greater risks will have greater returns. This adjustment makes it easier to compare, for example, the performance of a diversified universal bank (which has relatively low risk) with the performance of an investment bank (which has relatively high risk).

These two dimensions reveal how and why a company's true capital-market performance might vary from its TSR. When converted to RTSR, for example, a company's TSR will be adjusted upward if it posted strong gains despite a weak local market. Alpha adjusts the company's excess return downward if the business involves greater underlying risk. If a company has a high RTSR and a low or negative alpha, it means that although the stock outperformed the local market, the return was not high enough to compensate for the risk taken by the investors.

The formal definition of *RTSR* for stock *S* in local market *M* is as follows:

$$RTSR(S,M) = (1+TSR(S)) / (1+TSR(M)) - 1$$

The formal definition of alpha for stock *S* in local market M is as follows:

$$\alpha = r_i(S) - (r_f + (\mu_m - r_f) \cdot \beta(S))$$

where alpha is the excess return of stock *S*, calculated by the difference of the realized return of the stock $r_i(S)$ above what would be predicted by the capital asset pricing model (CAPM). The CAPM predicts the expected return of stock *S*. It includes:

- The risk-free rate r_f
- The excess return of the market $(\mu_m - r_f) \cdot \beta(S)$, derived from the average return of the domestic market *M*, μ_m, over r_f, and β, which is the volatility of stock S compared to the domestic market *M*; alpha directly measures the percentage excess return of the stock.

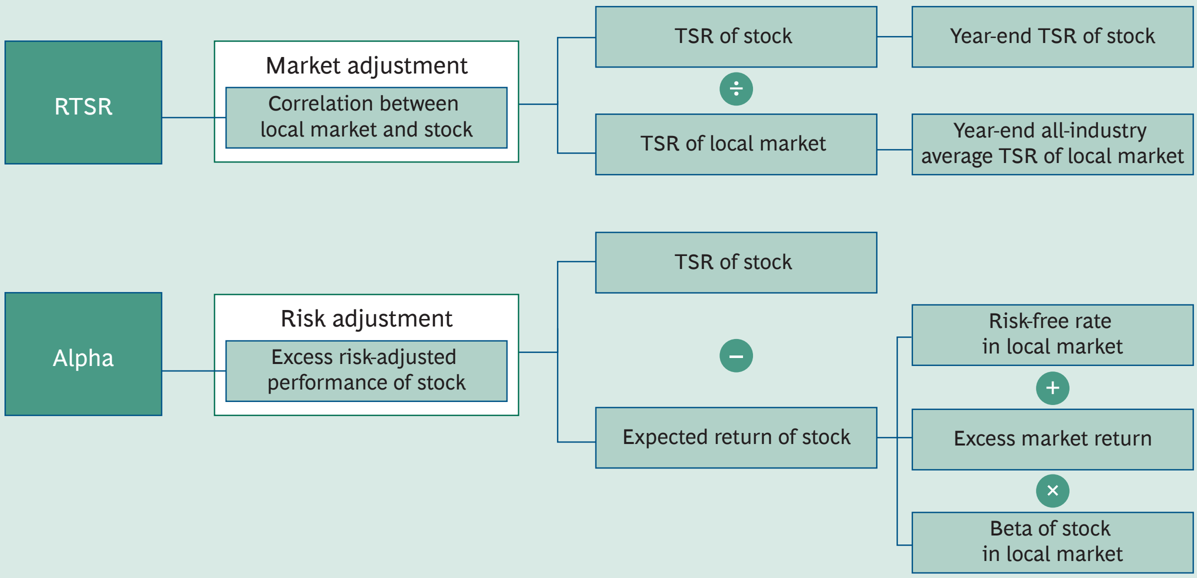
Return on equity (ROE). ROE is defined as after-tax profits divided by the average equity capital.

Cost of equity (COE). Company-specific COE is computed for every year based on the capital asset pricing model (CAPM), with ambient total national markets as reference markets. Betas are calculated over two years on a weekly basis.

PE multiple. The PE multiple, or price-to-earnings multiple, is defined as the end-of-year market capitalization divided by the after-tax profit.

Cost-to-income ratio (CIR). CIR is a widely used efficiency measure in banking; it is calculated by dividing total operating costs by total operating income.

RTSR Adjusts TSR for Local Market Influence, while Alpha Adjusts TSR for Volatility of Stock Compared to Local Market



Source: BCG analysis.

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