Stability and Profitability in Banking: The Handelsbanken Model

ISFI Conference
Reykjavík, June 12th, 2013

Niels Kroner, Barclays Capital Professor of Applied Finance
nkroner@eu.spb.ru
My involvement with Handelsbanken and other banks

Management consultant in Financial Institutions Group (1999-2006), working with a handful European banks.

Director of Group Strategy & Planning

Partner and Senior Financials Analyst, responsible for $150m stake in Handelsbanken, frequent CEO/CFO/… interviews with Handelsbanken as well as numerous other banks in Western and Eastern Europe.

Transformed in depth know-how into 2009 book about Handelsbanken (Harriman House).

Dual position: 1) Barclays Capital Professor of Applied Finance at European University at St. Petersburg, 2) Executive Chairman of AEE Renewables (a Handelsbanken client...).
Agenda

• Is Handelsbanken a model of profitability and stability?

• How does Handelsbanken's model work compared to other banks?

• What aspects of its model could / could not be applied to Iceland?
Handelsbanken delivers superior shareholder returns

European banks’ total return, 5 years

Outperformance is financially driven by consistently higher and less volatile return on equity.


* Comparable banks: SEB, Nordea, Swedbank and since 2003 also Danske Bank and DNB.
Handelsbanken is one of the few European banks that have eschewed government support, rights issues and reliance on ECB funding since 2007

<table>
<thead>
<tr>
<th>SEK bn **</th>
<th>Handelsbanken</th>
<th>SEB</th>
<th>Swedbank</th>
<th>Nordea</th>
<th>DNB</th>
<th>Danske Bank</th>
</tr>
</thead>
<tbody>
<tr>
<td>Dividends 2007 - 2012</td>
<td>34.5</td>
<td>17.8</td>
<td>17.7</td>
<td>54.2</td>
<td>28.3</td>
<td>12.8</td>
</tr>
<tr>
<td>Proposed dividend 2013 *</td>
<td>6.8</td>
<td>6.0</td>
<td>10.9</td>
<td>12.1</td>
<td>2.2</td>
<td>0.0</td>
</tr>
<tr>
<td>Rights issue(s)</td>
<td>-14.7</td>
<td>-27.5</td>
<td>-21.5</td>
<td>-16.2</td>
<td>-31.4</td>
<td></td>
</tr>
<tr>
<td>Repurchase of shares</td>
<td>2.2</td>
<td>6.2</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td><strong>Total transactions with shareholders</strong></td>
<td>43.5</td>
<td>9.1</td>
<td>7.3</td>
<td>44.8</td>
<td>14.3</td>
<td>-18.6</td>
</tr>
</tbody>
</table>

As % of market cap. 31 Dec 2006  33%  6%  6%  17%  10%  -9%

* Analysts consensus for DNB. Danske Bank as communicated in Q3 report.
** For Nordea, DNB and Danske exchange rates to SEK as at 31 Dec 2012

Source: Handelsbanken, Morgan Stanley
Constant credit policy over the cycle leads to countercyclical lending behaviour and provides lending to the economy when most banks retreat

Sweden lending to non-financial corporations
Agenda

• Is Handelsbanken a model of profitability and stability?

• How does Handelsbanken's model work compared to other banks?

• What aspects of its model could / could not be applied to Iceland?
How do they do it?

Recipe one: use branch model and unique credit approach to keep loan losses low

Recipe two: transform conservative risk stance into funding cost advantage

Recipe three: use branches to achieve outstanding customer satisfaction and transform it into higher margins

Recipe four: use customer selection and branch model to become cost leader

Consistent, steady growth
Sustainable superior profitability
Stable business model
The branch is the centre of Handelsbanken’s philosophy (“The branch is the bank”)
Recipe one: use branch model and unique credit approach to keep loan losses low

Loan losses in % loan volume

-2 0 2 4 6 8 10

* From 1997 incl. Stadshypotek
** SEB, Nordea (Nordbanken nationalised 1992, Gota Bank nationalised 1992) and since 1995 Swedbank
*** SEB, Nordea, Swedbank, Danske Bank, DnB Nor
Core elements of the Handelsbanken model: a differentiated perspective on risk

<table>
<thead>
<tr>
<th>Macro risk categories with no informational advantage = manage down / avoid</th>
<th>Risk categories with informational advantage for banks = carefully accept</th>
</tr>
</thead>
<tbody>
<tr>
<td>Sectoral / country credit risk</td>
<td>Customer credit risk</td>
</tr>
<tr>
<td>Interest rate risk</td>
<td></td>
</tr>
<tr>
<td>FX risk</td>
<td></td>
</tr>
<tr>
<td>Trading risk</td>
<td></td>
</tr>
<tr>
<td>Investment risk</td>
<td></td>
</tr>
</tbody>
</table>
What risks not to take: Handelsbanken has one of the lowest proportions of trading asset* of total balance sheet

<table>
<thead>
<tr>
<th>Bank</th>
<th>2007</th>
<th>2011</th>
</tr>
</thead>
<tbody>
<tr>
<td>RBS</td>
<td>50%</td>
<td>60%</td>
</tr>
<tr>
<td>Deutsche</td>
<td>50%</td>
<td>40%</td>
</tr>
<tr>
<td>BNP</td>
<td>20%</td>
<td>30%</td>
</tr>
<tr>
<td>Barclays</td>
<td>25%</td>
<td>31%</td>
</tr>
<tr>
<td>Société Générale</td>
<td>10%</td>
<td>15%</td>
</tr>
<tr>
<td>HSBC</td>
<td>10%</td>
<td>15%</td>
</tr>
<tr>
<td>Credit Agricole</td>
<td>0%</td>
<td>5%</td>
</tr>
<tr>
<td>Nordea</td>
<td>0%</td>
<td>5%</td>
</tr>
<tr>
<td>Standard Chartered</td>
<td>0%</td>
<td>5%</td>
</tr>
<tr>
<td>Commerzbank</td>
<td>0%</td>
<td>5%</td>
</tr>
<tr>
<td>Dimece</td>
<td>0%</td>
<td>5%</td>
</tr>
<tr>
<td>BBCE</td>
<td>0%</td>
<td>5%</td>
</tr>
<tr>
<td>KBC</td>
<td>0%</td>
<td>5%</td>
</tr>
<tr>
<td>SEB</td>
<td>0%</td>
<td>5%</td>
</tr>
<tr>
<td>Intesa Sanpaolo</td>
<td>0%</td>
<td>5%</td>
</tr>
<tr>
<td>Swedbank</td>
<td>0%</td>
<td>5%</td>
</tr>
<tr>
<td>Rabobank</td>
<td>0%</td>
<td>5%</td>
</tr>
<tr>
<td>Londes</td>
<td>0%</td>
<td>5%</td>
</tr>
<tr>
<td>Handelsbanken</td>
<td>0%</td>
<td>5%</td>
</tr>
</tbody>
</table>

* AfS and held for trading

Source: Liikanen report, Handelsbanken
Basic principles of the credit process at Handelsbanken

Credit policy
• Same across markets
• Specific to each customer – no portfolio approach (e.g., no “good” or “bad” industries)
• Unchanged over the business cycle (no tightening or relaxation of lending rules)

Organisation
• Branches are responsible for all credit decisions and bear full economic responsibility
• Lending only to customers with substantive presence near the branch
• Region and headquarters merely review larger credit decisions
• No separation of roles (e.g., no separate workout unit, no split between sales and credit book management, no split between relationship and lending authorisation capacity)
• Strong credit culture (e.g., loan losses are bad)
• Focus not just on initial decision but also ongoing management (documentation, early restructuring)

Credit guidelines
• Individual assessment of repayment capacity (no automation of credit scoring etc.), equal emphasis on quantitative and qualitative criteria
• Credit is only granted to customers that have the ability to repay (no loans based on collateral alone, no relaxation of credit standards in return for market share growth or high margin loans), pricing follows on market levels if they are sufficiently attractive to the bank
• Usually looking for collateral (e.g., 55% of corporate exposure and 86% of retail exposure collateralised) and very clean documentation
Credit organisation at Handelsbanken

Final decision for ...

70 (59)  28 (34)  2 (7)

2012 (2007)
Branches tend to make safer credit decisions

IRB corporate exposure distribution by PD classes 2012
Recipe two: transform conservative risk stance into funding cost advantage

Source: Reuters, Handelsbanken
Recipe two: transform conservative risk stance into funding cost advantage

5yrs CDS spread

Handelsbanken

ITRAXX Financials

RoE before loan losses

Peer group weighted average *
Recipe three: use branches to achieve outstanding customer satisfaction and transform it into higher margins

Source: EPSI
Handelsbanken’s branches have much wider decision-making powers than at most other banks – closer to franchise model

**“Best practice”**

• Branches are sales channels with very limited decision making powers
• Products are designed and priced centrally
• Marketing is done centrally
• Branches gather information for loan decisions, which are then taken elsewhere
• Primarily managed via sales targets

**Handelsbanken approach**

• Branches act like independent little banks with broad discretion on business plans – a new branch starts with the branch manager's business plan
• There is no "Handelsbanken business plan"
• Banks are free to decide customer selection, product offering, local marketing, pricing...
• ...and without their say no loan decision is made
• Primarily managed via profitability targets (cost/income ratio, loan losses) and customer satisfaction
• Only difference to independent bank: tied into bank-wide IT system and Treasury
What is the role of the regional head office and central business areas?

**Regional head office**
- Credit review (but 70% of loans decided on branch level only)
- Coaching and benchmarking of branches
- Establish new branches

**Centre**
- Product areas (mutual funds, life insurance products, mortgages) provide products and sales support, can be called into customer meetings by the branch
- Credit decision review and annual audit of branches
- IT/Operations: bank-wide uniform systems and processes, aim to support branch operations (e.g., reduce workload, suggest opportunities)
Example of a Handelsbanken branch (1/2)

Branch office operations in Great Britain – example of a newly-opened branch

Profile of a newly-opened branch (Scarborough):
Four employees with a total of 145 years of banking experience, 85 of them in the town
Each of them has only had one previous employer
All the employees live locally
Area: "Small and medium business’ town" with a population of 140,000
The branch broke even after 17 months

Number of active customers, ex branch opened in 2007

- Corporate
- Private

<table>
<thead>
<tr>
<th>Quarter</th>
<th>Corporate</th>
<th>Private</th>
</tr>
</thead>
<tbody>
<tr>
<td>Q1 2007</td>
<td>0</td>
<td>0</td>
</tr>
<tr>
<td>Q1 2008</td>
<td>10</td>
<td>20</td>
</tr>
<tr>
<td>Q1 2009</td>
<td>30</td>
<td>40</td>
</tr>
<tr>
<td>Q1 2010</td>
<td>50</td>
<td>60</td>
</tr>
</tbody>
</table>
Example of a Handelsbanken branch (2/2)

- Karlavägen is an old branch (founded 1924) in an affluent area in Stockholm
- It serves 2300 private customers and 450 corporate customers in a tiny area that covers just a few blocks
- The branch has a different structure from the one in Scarborough

<table>
<thead>
<tr>
<th>Scarborough (1)</th>
<th>Karlavägen (2)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Branch manager</td>
<td>Branch manager, deputy manager</td>
</tr>
<tr>
<td>Corporate banking manager</td>
<td>Two corporate banking managers</td>
</tr>
<tr>
<td>Two product specialists (Trade Finance, Asset Finance)</td>
<td></td>
</tr>
<tr>
<td>Individual bank manager</td>
<td>Two managers working with housing associations and mortgage loans</td>
</tr>
<tr>
<td>Account manager</td>
<td>Two tellers</td>
</tr>
</tbody>
</table>
Branch focus survives in the internet age

Meet the team

Contact details

:: Branch Manager
   Roy Budgett

:: Corporate Banking Managers
   Navid Shah
   Tony Virtanen
   Richard Shapley

:: Individual Banking Manager
   Gary Moore
   Ian Alborough
   Aman Teeduck
   Paul Lockley
   Steven Trump

:: Offshore Private Banking
   Ian Alborough
   David Killick

Rosina Galvin
Mobile: 07667 557039

Tel: 020 7930 3985
Fax: 020 7930 3954
Email: rgs05@handelsbanken.co.uk
Handelsbanken’s unusual incentive system without bonuses
Recipe four – customer selection

Customer segment

Demand complex and tailor-made solutions

Handelsbanken’s target:
Better cash flow than average

- Do not generate much profit
- Generate more costs than income for their bank
Handelsbanken’s approach to customer selection and acquisition is very different to “best practice”

**“Best practice”**
- Bank-wide customer segmentation
- Uniform service model
- Active nationwide marketing
- Special offers to attract new clients
- Product pricing decided centrally
- Staff have sales targets
- Branches are sales outlets

**Handelsbanken approach**
- Branch decides if and how to segment customers and which customers it wants to target (new branches: business plan by branch manager, taking into account local specifics)
- Branch decides service model
- Only very limited, local marketing
- Customers acquired by introductions and work of mouth
- No hook product offers (compete on service, not price)
- Branch decides on pricing
- No sales targets (but branch benchmarking)
- Branches are entrepreneurial franchises
Branch model not just good for *profitability* but also for *growth*

**Income and expenses trend, new opened branches in Great Britain**

Refers to the average of 80 branches opened in Great Britain 2000 – 2011:Q1
Lack of overhead and good margins create attractive cost position even in small markets

**FY 2012 - branch numbers and cost/income ratio**

<table>
<thead>
<tr>
<th>Country</th>
<th>Handelsbanken</th>
<th>Local peers</th>
</tr>
</thead>
<tbody>
<tr>
<td>Sweden</td>
<td>461 35.1%</td>
<td>310 46.1% Swedbank Retail (Sweden)</td>
</tr>
<tr>
<td>UK</td>
<td>133 50.6%</td>
<td>231 50.7% Nordea Retail Sweden</td>
</tr>
<tr>
<td>Denmark</td>
<td>54 54.6%</td>
<td>169 58.5% SEB Retail Sweden</td>
</tr>
<tr>
<td>Norway</td>
<td>49 35.8%</td>
<td>44 49.5% Danske Bank Retail Sweden</td>
</tr>
<tr>
<td>Finland</td>
<td>45 48.4%</td>
<td>3000 53.3% Lloyds TSB Core business</td>
</tr>
<tr>
<td>Netherlands</td>
<td>13 67.8%</td>
<td>2200 47.9% RBS UK Retail and UK Corporate</td>
</tr>
</tbody>
</table>

Handelsbanken data includes their branch numbers and cost/income ratio. The local peers listed are their respective retail banks in each country with their branch numbers and cost/income ratio. The local peers include:

- **Sweden**: Swedbank Retail (Sweden), Nordea Retail Sweden, SEB Retail Sweden, Danske Bank Retail Sweden, Lloyds TSB Core business, RBS UK Retail and UK Corporate, Barclays UK Retail and Business Banking, HSBC.
- **UK**: Danske Bank Retail Denmark, Nordea Retail Denmark.
- **Denmark**: DnB Nor Retail, Nordea Retail Norway.
- **Norway**: Danske Bank Retail Norway, Nordea Retail Norway.
- **Finland**: Nordea Retail Finland, Danske Bank Retail Denmark.
- **Netherlands**: ABN Amro overall bank, Rabobank overall bank.
Agenda

• Is Handelsbanken a model of profitability and stability?

• How does Handelsbanken's model work compared to other banks?

• What aspects of its model could / could not be applied to Iceland?
Considerations for Iceland

**Positive aspects**

- Model is inherently local through branch focus
- Intl. operations demonstrate that model does not require any large scale
- Low risk profile and low reliance on sovereign bailouts desirable for Iceland
- Balanced funding model on branch level would have avoided wholesale-driven credit boom of Icelandic banks
- Alignment of long-term interests between stakeholders

**Problematic aspects**

- Model works as universal banking model in Sweden but even better in other countries where SHB can cherry pick only affluent customers
- Low risk appetite appears incompatible with existing loan books / established banking products in Iceland (e.g., inflation-linked mortgage, FX loans to private customers)