

Wharton Financial Risk Roundtable 2003
Measuring and Managing the Value of Financial Institutions:
Integrating External and Internal Valuations

In May 2003 the Wharton Financial Institutions Center (WFIC) held its Sixth Annual Financial Risk Roundtable, "Measuring and Managing the Value of Financial Institutions: Integrating External and Internal Valuations," in Philadelphia at the Wharton school. Since its inception in 1998, the Financial Risk Roundtable has been generously supported by the Oliver, Wyman Institute, now the Mercer Oliver Wyman Institute (MOWI). The partnership reflects closely aligned interests: WFIC is the leading academic institute focused on the financial services industry, and MOWI is a unique cooperative undertaking between Mercer Oliver Wyman and leaders in the international academic community. The mission of each is to facilitate and accelerate knowledge transfer, in both directions, between academia and the financial services industry.

Key Wharton faculty responsible for the Roundtable include Franklin Allen (Nippon Life Professor of Finance, Professor of Economics, and Co-Director of the WFIC), Francis X. Diebold (W.P. Carey Professor of Economics, Professor of Finance and Statistics, and Senior Fellow of the WFIC), and Richard J. Herring (Jacob Safra Professor of International Banking, Professor of Finance, Director of the Lauder Institute, and Co-Director of the WFIC). Key Mercer Oliver Wyman professionals include John P. Drzik (President), Andrew Kutirzkes (Managing Director), and Thomas C. Wilson (Managing Director).

The Roundtable is a day-long event, consisting of three related sessions, each of which in turn features several panelists. Speakers in 2003 included Mark J. Flannery (BankAmerica Eminent Scholar of Finance and Professor of Finance, University of Florida), H. Rodgin Cohen, Esq. (Chairman, Sullivan & Cromwell), Diane Glossman (former Managing Director and Head of U.S. Bank and Brokerage Research, UBS Warburg), Robert H. Hughes (Vice President, Keefe, Bruyette & Woods), Michel Crouhy (Senior Vice President for Business Analytic Solutions, CIBC), Andre F. Perold (George Gund Professor of Finance and Banking, Harvard Business School), Thomas C. Wilson (Managing Director, Mercer Oliver Wyman), Dan Borge (former Managing Director, Bankers Trust), W. Keith Smith (former Vice Chairman, Mellon Financial Corp.), and George Pastrana (Managing Director, UBS Warburg).

The relationship between financial institutions' external valuations and internal performance metrics remains, at best, incompletely understood. Hence the 2003 Roundtable explored the crucial issues of how financial institutions are valued by the market, and how they measure value and allocate capital internally, in an attempt to draw the implications for managing to maximize joint internal/external value.

The Roundtable was launched by a dinner featuring Todd Thompson (CFO, Citigroup), who addressed the central theme of the Roundtable, the intersection of valuation and strategy, commenting on both the valuation of Citigroup as a company and the valuation of other companies by Citigroup. He focused on the key factors affecting financial institution P/E ratios, with special focus on earnings growth, earnings stability, transparency, and communication. One

general theme, which was echoed throughout the following day, was that after earnings growth, the stability of earnings is the next most important determinant of external valuation. Hence effective risk measurement and management can increase shareholder value.

The following day began with a discussion of external valuation, focusing on aspects of operating performance, risk management, governance, and communication. The objective, of course, was to determine the factors influencing market valuations of financial institutions. Diane Glossman and Robert Hughes focused on “how to do things right” to maximize valuation, and Rodgin Cohen warned of specific reputational risk pitfalls to which banks are severely exposed, and which can destroy value quickly.

Glossman and Hughes stressed that the perceived risk profile of a financial institution has become a major criterion in the external valuation process, and that the opacity of the risks facing banks is a major determinant in their valuation and largely responsible for the typically low P/E ratios at which they trade. In the current environment, moreover, investors are broadening their focus well beyond traditional market and credit risks to include operational and reputational risks.

Cohen focused precisely on reputational risk, which he defined as a sudden loss of valuation following a legal action or compliance failure. He noted that banks are especially vulnerable to reputation risk because they are subject to a lengthy and complex regulatory regime, and he posed three key questions that banks must address: how to limit and control reputational risk, how to communicate with external constituencies when incidents occur, and how to assess reputational risk. To limit reputational risk, institutions must invest in processes, procedures and controls. To communicate problems, releases should be prompt, fact-driven, and updated as new facts become available. To assess reputational risk, assess the firm’s compliance effort. A state-of-the-art compliance effort won’t eliminate reputational risk, but it will reduce the frequency and severity of incidents as well as the severity of regulatory response.

The Roundtable then turned to matters associated with internal, as opposed to external, valuation. Specifically, the discussion focused on the specifics of a coherent internal value measurement framework, including aspects of performance measurement, optimal capital level, and cost of capital. The objective was to determine the elements of a best-practice internal performance measurement, valuation and capital allocation framework for financial institutions.

Andre Perold added that, in addition to the opacity of their risks, a lower-than-average P/E for banks may be explained by the unusually high cost of bankruptcy in this sector. Hence, contrary to traditional finance theory, prudent risk management and/or diversification may create value for the shareholders of a financial institution, by reducing these high bankruptcy or “deadweight” costs. However, there are still major hurdles and a long way to go before frontier academic risk measurement results are fully integrated into strategic decision making at financial institutions.

Thomas Wilson concurred that banks are still relatively unsophisticated in their internal application of risk analytics. For example, according to a survey by Mercer Oliver Wyman, more than 75% of banks are using a common or similar hurdle rate across all their activities. Wilson went on to demonstrate that, all else equal, the P/E ratio, and hence the implicit discount rate used

by the market is dependent on a bank's risk, defined variably as the bank's segment, leverage, or idiosyncratic risk. Hence, by using a common hurdle rate, most banks are subsidizing higher risk businesses at the expense of lower risk businesses and destroying shareholder value.

Finally, the Roundtable focused on the management challenges associated with joint use of external and internal valuations to guide strategy. That is, after having established frameworks for both internal and external valuation, it assessed their similarities and differences and drew the implications for how financial service firms should manage high-level institutional strategy to maximize value. Issues included the challenges faced by financial institutions in terms of managing value (as opposed merely to measuring it), building a culture of value maximization, and the role throughout of the CFO and CRO.

Keith Smith, who guided the transition of Mellon from a retail bank to a private bank and asset management firm, focused not on risk, but on return. He noted that there are two ways to increase earnings and eventually P/E: increase revenues or reduce costs. Although cost reductions achieved by various means were fashionable in the 1990s, Smith stressed the equal importance of revenue enhancement, which he achieved through a series of shrewd mergers.

Dan Borge, who developed the RAROC concept while head of global research and corporate strategy at Bankers Trust in the 1970s and 1980s, worried that bank risk management culture may not be up to par with the analytics available. Borge noted that Bankers Trust adopted RAROC to pull itself from the brink in a period of poor performance. However, in the absence of intensely strong commitment at the management level and without a strong risk culture, the value of risk analytics to a financial institution may be much less high. Hence the importance of growing a risk culture from the top down.

The 2003 Financial Risk Roundtable is part of a growing and distinguished tradition. Previous Roundtables include Market Risk Measurement and Management: VaR and Beyond (1998), Measurement and Management of Global Financial Risk: Crashes, Crises and Contagion (1999), Quantification and Trading of Credit Risk (2000), Conglomeration, Consolidation and Convergence in the Financial Services Industry (2001), and Assessing and Managing Operational Risk (2002). The many repeat participants testify to the Roundtable's ongoing success and have produced an ongoing "family" with continuity and commonality of interests. As we look to the future, we look forward to maintaining our tradition of intense and lively discussion, featuring extensive audience participation surrounding short talks by leaders both from academics and industry.