

FINANCIAL SERVICES CONSULTING

# Financial Risk Conference

20 June 2007 – Claridges, London

## Valuing Financial Services Institutions Challenges and Opportunities

### Speakers

Sir Andrew Large  
Senior Advisor for  
Oliver Wyman

Dr Rolf-E. Breuer  
Former Chairman of  
the Supervisory Board  
Deutsche Bank AG

Dr Thomas Garside  
Managing Director  
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Huw Van Steenis  
Managing Director  
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José Luis de Mora  
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Dr Christian Pedersen  
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Professor David Llewellyn  
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Professor William Perraudin  
Professor of Finance  
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John Drzik  
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Oliver Wyman

Professor Ingo Walter  
Seymour Milstein Professor  
of Finance, Corporate  
Governance and Ethics  
NYU

Thomas Huertas  
Director, Wholesale  
Firms Division  
Financial Services Authority

# Conference Highlights

The programme is divided into three sessions that will provide a forum for an interactive discussion about the following crucial issues:

- What trends and approaches are being used to value stocks? How do investors rate financial institutions relative to other sectors, and how can the sector discount be addressed?
- How can risk and finance functions better support the valuation process? How can we improve and measure performance?
- How can we increase shareholder value? In which regions and sectors is growth expected? How can we place a greater focus on valuation growth?

# Programme

## Morning

08:45 – 09:00 Registration and Welcome Coffee

09:00 – 09:40 Keynote address

### **Valuing Financial Services Institutions: Challenges and Opportunities**

Sir Andrew Large, Senior Advisor for Oliver Wyman

09:40 – 10:55 Session 1

### **Valuation Approaches and Financial Services Stocks**

- Valuation: The eternal challenge
- Beauty in the eye of the beholder: Who wants to buy which stocks – and why? Is there a convergence in valuation across continents?
- Bank Valuation from First Principles

*Chairman:* Dr Thomas Garside, Managing Director, Oliver Wyman

Huw Van Steenis, Managing Director, Morgan Stanley

José Luis de Mora, Group Corporate Development, Santander

10:55 – 11:10 Refreshment break

11:10 – 12:50 Session 2

### **Supporting and Enhancing Valuations**

- The risk management tool kit, and how to use it
- Aligning risk with corporate Strategy
- Disclosure strategies
- How best-practice risk management enhances shareholder value (and sub-standard risk management destroys it)
- Aligning risk with corporate strategy
- The role of credit risk management and transparency of process in enhancing bank valuations

*Chairman:* Dr Christian Pedersen, Director, Oliver Wyman

Dr Thomas Wilson, General Manager, Insurance Risk Management, ING

Dan Borge, former Managing Director and Partner, Bankers Trust

Gene Guill, Managing Director, Loan Exposure Management Group, Deutsche Bank

12:50 – 13:50 Lunch

## Afternoon

13:50 – 14:30 Keynote address

### **Future sources of Value – Threats and Opportunities**

Dr Rolf-E. Breuer, former Chairman of the Supervisory Board, Deutsche Bank AG

14:30 – 16:35 Session 3

### **Sources of Future Financial Institution Valuation Growth**

- Performance indicators and success factors: Lessons from recent SPI results
- Global Financial Intermediation: Is bigger and broader better?
- The evolving primacy of Shareholder Value
- A regulatory perspective of the future valuations
- Banks as Structured Products: Implications for Valuation

*Chairman:* John Drzik, President and Chief Executive Officer, Oliver Wyman

Professor Ingo Walter, Seymour Milstein Professor of Finance, Corporate Governance and Ethics, NYU

Professor David Llewellyn, Department of Economics, Loughborough University

Professor William Perraudin, Professor of Finance, Imperial College London

Thomas Huertas, Director, Wholesale Firms Division, Financial Services Authority

16:35 – 16:45 Closing Remarks

Dr Thomas Garside / Dr Christian Pedersen, Oliver Wyman

16:45 Drinks



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*Wharton Financial Institutions Center & Oliver Wyman  
Institute*

Valuing Financial Services Institutions  
Challenges and Opportunities

*20 June 2007*

This summary is intended to provide a flavour of the event, rather than an exhaustive transcription. Speakers' comments may have been edited for the sake of readability.



Keynote address:

**Valuing Financial Services Institutions: Challenges and Opportunities**

Sir Andrew Large, Senior Adviser for Oliver Wyman

The concept of value was challenging, suggested Sir Andrew Large as he opened the conference. Could such a multi-faceted concept really be stated as a single number? At what point in time did a given value apply? Value could differ according to the perspective taken – shareholders', managerial or social. Should a business be valued as a going concern, or in terms of its break-up value? And so on.

Value is nominally driven by the riskiness of the underlying assets: but given the increasing prevalence of risk transfer, risks were no longer just in the assets themselves. The speed and opacity of risk unbundling was such that it was impossible to keep up, even for supervisors – one reason that enthusiasm for centralized "risk registers" had waned. Increasingly, the focus would have to be on how good firms are at *managing* risk – that is, their process and risk management frameworks.

Given this complexity, Sir Andrew said he would set the scene, rather than offer solutions. There were two distinct issues: the valuation of assets, and the valuation of firms. A key concept in asset valuation today was that of fair value, which had been broadly embraced by the industry and its supervisors. But the relevant accounting regulations had not addressed a number of vital issues.

Who were accounts for – owners, who care about the economics as a going concern, or supervisors, who care about solvency? There were some blind spots: no supervisor would countenance deposits being valued at less than par for fear of undermining systemic confidence. There was the time spectrum: where was an institution on the spectrum for historic future? And should one address the increasing number of assets for which there are no observable prices, such as exotic derivatives?

One answer to this last question is to use models, but these themselves raise many questions. Models offer no idea of the market's depth (and thus the liquidity assumptions built into modelled prices), and it is hard to see how they can be calibrated in the absence of market prices. Models are hard to explain to shareholders, but subject to moral hazard on the part of those who would take them to be infallible. In short, Sir Andrew suggested, models were indispensable, but "fraught with danger for the unwary."

Prices were currently high in a wide variety of assets. Had investors got it wrong? Markets might always be right, but they were perhaps not always wise. Supervisors, for their part, found it hard to calibrate a response and had no idea of the "right" level anyway. This gave rise to substantial

systemic risk: everyone assumed in their valuations that they would be able to exit in an orderly manner, at market prices – but the herd behaviour that takes over in times of stress might dictate otherwise.

Moving on, Sir Andrew first considered the "macro determinants" of the valuation of firms. There was monetary policy: the impact if the firm failed. There was financial stability: how should firms be valued during times of stress, given that some were deemed "too big to fail"? And there was investor protection. The valuations of European pensions providers had been severely damaged by their failure to realise that society expected them to fulfil a duty of care to their customers. It was advisable, Sir Andrew said, to "get your thoughts straight" on the likely direction of public policy.

A second element of firm valuation was the business model, with particular emphasis on outsourcing. Funds and, increasingly, commercial banks were making use of disaggregated value chains – but how can value take account of the possibility that the outsourcer under-performed? How could the weakest link be factored into the valuation of the firm? This was a significant issue, as evidenced by the recent backlog of credit derivative documentation at hedge funds.

The valuation of a firm was also dependent on the passivity or otherwise of its investors. Passive investors were dependent on analysts and media for their information, and perhaps the accounts. But this might mean they do not appreciate the value a firm believes it holds. Active investors, by contrast, spot the value that passive investors leave on the table, and are motivated to realize it by effecting change – of structure, of management or of strategy.

Active investors look for tangible value: vague concepts like "synergy" wouldn't hold water. The question was: do they distil, or manipulate, market value? This would be an area of continuing interest, since it touches on difference in culture towards shareholders' interests in different countries.

To conclude, Sir Andrew offered some observations on future trends in financial services. First, information mismatch and inertia had prevented passive investors from becoming more active; he expected to see hedge funds and private equity "go mainstream".

Second, there would be increased scrutiny of stretched activity chains, with firms re-evaluating their balance of outsourcing and in-house operations. To cite an example from another industry, no-one ten years ago would have suggested that BP would need its own tanker fleet; but today that was looking like a good idea. Perhaps hedge funds would also think about bringing some of their more vulnerable operations in-house.

Finally, risk frameworks would play an increasingly important role in value. The emphasis was moving from solvency (as in Basel II) to a broader range of risks. Evaluating risk frameworks

would be a challenge, but value would be increasingly tied to the evidence of effective risk categorization, metrics and contingency planning.

### **Valuation Approaches and Financial Services Stocks**

Dr Thomas Garside – Managing Director, Oliver Wyman

Dr Garside said his presentation would draw heavily on Oliver Wyman's Shareholder Performance Index (SPI), a ranking of risk-adjusted performance for the world's largest financial services firm. The SPI showed the market performance of financial services firms to be strongly correlated both with the quality of their execution and their choice of business model, with strong clustering into groups of out-, medium- and under-performers. The most consistent performers were "selective conglomerates", which operate in carefully selected businesses, thus avoiding the vulnerabilities of monoline while still optimising risk and keeping complexity manageable. Successful examples generate additional value by "thinking like capital"; sharing back-end services where this generates value; managing risk pro-actively, from the top down; creating a strong, incentive-led culture focused on value creation; and through continuous innovation and incremental, value-led expansion.

Both conglomerates and monolines under-perform on a risk-adjusted basis. Conglomerates' price-to-equity (PE) ratios were around 15% lower than the sector in general; in particular, firms larger than about \$50 BN seem not to be able to deliver performance akin to that of smaller and nimbler firms. Some of this discount is explained by basic under-performance in terms of productivity and efficiency: academic work had demonstrated that the supposed economies of scale run out at quite a small firm size, although risk diversification benefits continue to be meaningful at much larger sizes. Monolines, for their part, deliver high raw returns – but this is outstripped, in terms of shareholder value, by their volatility, finite growth potential and strategic vulnerability. How could firms address the conglomerate discount? There were two issues: an expectations gap, and a strategy gap.

The expectations gap essentially means that the market finds it hard to accept that current management can achieve their strategic objectives. Communications are key in this respect:

firms that analysts consider to be transparent and reliable achieve higher PE ratios. The analysts want to know how the firms think about underlying economics; to see consistent disclosures, year after year; timely information on known issues, not "negative surprises", and to see where earnings are coming from in the firm – particularly in terms of the relative contributions of core businesses and discretionary investment or exceptional items. Another important aspect is to demonstrate effective management; companies that had outlined their value-based management approach had outperformed in the SPI.

There were three ways to close the strategy gap. First, the firm could take a targeted level of strategic risk. Being low-risk and predictable, or high-growth and high-risk, were both viable; the uncomfortable area is the middle ground occupied by poorly differentiated firms. Second, it could take steps to resolve the structural, strategic and resource-driven obstacles to the realization of its full revenue potential. Last, but not least, it could become a selective conglomerate – whether by expanding away from a monoline position, or by streamlining its business model by divesting businesses that do not conform to a chosen area of focus.

Huw van Steenis – Managing Director, Morgan Stanley

Mr van Steenis observed that the standout performers in financial services markets over recent years had been the so-called "new FIG" firms. Most alternative asset managers had smashed through initial earnings estimates by consistently exceeding analysts' expectations of their performance.

New FIG firms could "beat and beat and beat" earnings expectations because they were under-researched, he suggested; analysts were reluctant to cover their stocks and had made a bad job of predicting their future earnings. Analysts tend to take the last six months as their basis for future expectations, on the basis that "two data points make a trend", offering another chance to second-guess the market; and they were reluctant to accept that twenty-percent growth could be continued year-on-year.

There were still big opportunities for major earnings revisions among this group. The markets had not appreciated the potential for a "triple whammy" of higher AUM, higher performance fees and performance improvement. The public market values growth, but US investors pay more for growth firms than their European counterparts, with the gap rarely closing unless M&A took place. And investors are pricing in as "fast fade" for alternative managers, sharing analysts' scepticism about their ability to sustain their current strong performance.

European stock exchanges were also strong performers, and one of the few examples of the market genuinely re-rating cash flows. PE ratios for the sector have increased sharply since 2002, aided by cyclical and structural growth alongside strong cash generation and earnings that had

exceeded expectations. Activism was working in this sector, although European exchanges still attracted lower valuations than their US counterparts – partly justified by their low growth and continuing cautious attitudes.

Some of these effects also applied to European banks, which had performed sluggishly, said Mr van Steenis. Analysts failed to appreciate the optionality in their businesses, took recent performance as indicative of the future, and struggled to believe in sustained strong performance. Core banks were thus trading mostly on earnings revisions, with an overlay due to balance sheet re-leveraging and M&A.

Banks do have opportunities to improve their standing, he continued. For example, risk transfer had led fundamentally changed their dynamics, and should have led to a re-rating – but the market had not provided one. The answer was to explain now, wait patiently for the improvements to become manifest and accept the long-term rewards. Most investors do not believe in "sum-of-the-parts" valuation, leading to high-performing units being disregarded when their parents are valued.

Banks can also address how they are perceived: being misclassified in terms of strategic play and business model can have a deleterious effect on PE ratios. The basic play of large European banks – a bet on the macro-economy – might look gloomy now, so banks should highlight the macroscopic positives for their institutions, and express confidence about their ability to handle the negatives.

### **Supporting and Enhancing Valuations**

Dr Christian Pedersen – Director, Oliver Wyman

The presentations so far had highlighted the importance of market perception in financial services valuation, said Dr Pedersen. Analysts do not have a good view of multi-year earnings potential, or of the balance sheet, for two reasons. One was lack of disclosure; another was that finance and risk management do not directly support the disclosures that are made. Market perceptions of value depend on growth, return on equity (RoE) and cost of capital (CoC), each of which can be more or less directly supported by the financial and risk functions within banks.

The ambitions of investors, executives and line managers are being frustrated by lack of an appropriate framework. Investors will not accept sum-of-the-parts valuation, which makes it difficult to connect the external audience to the internal valuation models; they want "better earnings quality", but this remains ill defined. Executives cannot connect their objectives for risk

management to the external view; and line managers, for their part, are disconnected from the executives and not optimised in terms of reporting to analysts.

Few firms have made much progress in closing these gaps, with the exception of some monolines – and risk management has not been going in this direction in any case. Today, risk management often looks like an audit function: where is the consideration of P&L and risk-return? Economic capital captures solvency risk, but how is this usable in a quarterly earnings discussion? Is capital really the best metric for businesses that are characterised more by earnings volatility or reputation? Is risk linked to value, or just adding red tape to the already crowded control framework?

With Basel II implementation efforts petering out, there is an opportunity to rethink the way risk management is being done with a view to greater business relevance. Change has to start from the top: many of the relevant questions are falling through the gaps between strategic planning (owned by the CEO), financial management (the CFO) and risk appetite (the Board and CRO). These senior figures need to ask questions like "how do we measure value creation?" or "what should we do with our excess capital" and direct the organization to develop answers.

The framework that develops may differ considerably from the one currently in existence: it might focus on presenting "dividends at risk" or earnings volatility, for example. The risk function will also adapt: can it be more flexibly implemented to avoid "strangling growth", allowing more scope in pricing and so on? Is it worth operating a finance-led framework, supported by risk, as many non-financial companies do routinely?

Whatever the response, it will require a step-change in metrics and better co-ordination amongst central functions. Banks will try to link Basel II compliance measures with bank steering and performance management, linking internal business valuation models to risk frameworks and using top-down risk analysis to streamline the overall control framework. And Pillar 3 has set the benchmark for disclosures, another area of focus.

*Gene Guill – Managing Director, Loan Exposure Management Group, Deutsche Bank*

Investors' fear of the downside risk of overly concentrated loan portfolios is one contributing factor in the banking industry's low PE ratios, said Mr Guill. That had been demonstrated in the downturns of 1991-02 and 2001-02, in which Deutsche had been penalised more than it perceived as fair, prompting it to establish its loan exposure management group (LEMG) and improve its dialogue with investors on this subject.

The traditional model of banking had been eroded because of the information available to investors who could now invest directly in credit – undermining the traditional role of commercial banks as intermediaries. At the same time, liquid credit markets had given banks the

tools to actively manage their loan books. These two factors point to the need for a rethink of disclosure with respect to lending activities.

Credit portfolio management was created to improve the financial performance of large corporate loan portfolios, home to some of the largest, most misunderstood and underestimated risks in banking. Banks spend millions of dollars on this activity in the hope of preventing much more in terms of losses – but how do you communicate its value to investors, particularly since there are no best practices to speak of and no consistency in how different banks disclose their activity?

In Deutsche's case, the answer is to manage loan credit according to simple policies, whose nature and consequent effect on performance is easily communicated. The LEMG is required to hedge open exposures above specified thresholds based on customer ratings; it is allowed to over- or under-hedge within defined range, but cannot otherwise make exceptions for liquid names. The hedge ratio for its international portfolio is approximately 45%, reducing its economic capital by about 70% – figures that are easy to explain to investors.

Since liquid names – predominantly large cap – can be revisited after the point of origination, it is logical to treat them differently (in terms of policies and procedures) to the illiquid middle market and SME portfolio, which must typically be held to maturity. The liquid portion can be reported according to fair value accounting, which reveals the loan portfolio's true economics, enabling its credit risk to be managed as spread risk (rather than default risk) and allowing managers to make economically based decisions about transactions. This also improves transparency and provides benchmarks for performance measurement.

Banks should perhaps take a lead from credit asset managers when it comes to disclosure, suggested Mr Guill: the routinely report what products they use, what risk management they employ and fair-value P&L. Banks, analogously, should disclose the mandate of their CPM units, a description of the actively-managed assets and risk management tactics, and results achieved in terms of hedges taken, reductions in single-name and portfolio risk and overall financial performance.

*Dr Thomas Wilson – General Manager, Insurance Risk Management, ING*

Dr Wilson said he was "plagued on a regular basis" by the question "how does risk management create shareholder value?" The answer, needed to justify his existence as a senior risk manager, is unfortunately difficult to demonstrate quantitatively. In bull markets, risk management can be seen as a constraint or limiting the beta of the company; in bear markets, nobody counts the

“bullets missed” by the firm. Risk managers have to take the leap of faith that if they continue to do the right things, consistently, shareholders will ultimately benefit.

What are the "right things" to do? First, risk underwriting: making sure that products are structured, underwritten and priced appropriately. In the case of an insurer, these may be long-lived and illiquid; no amount of strategy will rectify flawed underwriting. Second, risk controlling: is the firm's risk profile transparent and well understood by management, and is risk within delegated authorities? This is accomplished through risk reporting and limit controlling. Third, the link between risk and strategy: is the risk profile consistent with the firm's risk bearing capacity, risk appetite and its strategy for creating shareholder value? Are the rewards appropriate to the risks, and where can the risk-return profile be improved? Where should the firm invest for growth? Poor strategy and great execution will lead to disaster – as will the reverse.

The final stage is disclosure: making sure that the risk-return strategy is transparent to analysts, shareholders, ratings agencies and regulators. There are three keys: solvency, sensitivity and responsiveness. Insurers must be able to reassure regulators and rating agencies that they are appropriately capitalised and thus able to withstand shocks. Sensitivities are important for analysts to update earnings forecasts; and responsiveness is the ability to disseminate that understanding quickly and accurately in response to requests from the market.

There is another challenge associated with disclosure however: the information must not only be available, but correctly interpreted, leading to appropriate valuation multiples. This is a challenge for the insurance industry, for whom valuation is a much more complex affair than for banks, in part because the business model is not well understood in terms of spread or margin and in part because insurance accounting typically does not give a good picture of the underlying economics. This is reflected in the substantial "opacity discount" applied to insurance shares.

What are insurers doing in response? Many in the European industry are pushing forward along the fair-value accounting path – or market-consistent embedded value, in insurance parlance – but the value of this approach is hotly debated both by insurance managers and analysts. Some believe it is useless compared with earnings; others, that it will aid the drive towards transparency; and the remainder have no clear opinion. Dr Wilson, for his part, said he believed the financial services industry to be headed towards fair value, perhaps supplemented by more traditional performance ratios and metrics, and this was a trend to be embraced in a controlled manner.

Keynote address:

**Future Sources of Value: Threats and Opportunities**

Dr Rolf-E. Breuer – former Chairman of the Supervisory Board,  
Deutsche Bank

Dr Breuer noted that there had been strong winds of change in the financial services industry recently – but that this was not really anything new. Most European markets were now mature, he noted, with seventeen of the EU's member states host to highly concentrated banking markets. So banks were looking elsewhere for growth – to Central and Eastern Europe (CEE), or to new or underserved products.

M&A volumes had quadrupled in the European banking industry, with deals cutting across national boundaries and transaction sizes of €50 BN plus within reach. Unicredito/HVB had been a landmark cross-border deal, while the struggle for ABN Amro was an example of the complications that could result. Even without M&A, non-domestic competitors would continue to win market share as integration and consolidation continued.

New products, such as exchange-traded funds, credit and commodity derivatives, were coming into the limelight as investment banks looked for new sources of growth; commercial banks' business model was moving away from on-balance intermediation and towards capital markets-based business models. That demanded active risk and capital management, including a migration away from originate-and-hold towards the securitisation and sale of assets.

Where could banks look next for value? Dr Breuer suggested that the answers could be found in five "megatrends", each of which posed threats and opportunities. The first was the drive towards emerging markets, widely recognized as holding potential for future growth. However, there were still challenges associated with operating in these markets. Political and legal risks still existed, and regulatory frameworks were often still underdeveloped, restrictive and lacking independence.

Dr Breuer wondered if banks were paying enough attention to the small size of these markets in revenue terms: the only substantial CEE economy, he suggested, was that of Poland. But there were still opportunities where countries were under-banked with respect to their GNP, and a careful and managed approach could still generate returns that outweighed the risks.

The second megatrend was demographics. The ageing of the European population had a direct effect on the banking industry. In macroeconomic terms, a shrinking and greyer workforce would slow growth rates, respectively, become less productive, limiting the expansion potential for financial services in Western Europe. On the other hand, the inability of health and social security programs to deliver on their promises had forced individuals to make their own provisions by increasing savings. That was good for banks, which could offer advice, portfolio

management services and products designed to provide security; asset managers, in particular, could expect to benefit for many years to come.

A third megatrend was climate change, with more implications for banking than one might assume at first glance. One consequence of climate change would be an increase in credit risk premiums over time for countries and industries affected by the increased frequency and severity of climate-related phenomena such as windstorms and floods. Other industries, such as agriculture and tourism, would suffer higher volatility of earnings. Consequently, banks would raise their risk ratings for the affected sectors and be more cautious in lending; they might also re-price existing assets, including bonds as well as loans.

The opportunity for the financial services industry lay in the industries that would cater to climate-specific needs: construction, for example, to build new transportation, flood prevention and irrigation schemes. All of these would require finance, as would energy-efficient drives. There would also be demand for products to hedge climate risks, including carbon trading, catastrophe-linked bonds and weather derivatives. Overall, climate change would probably be a positive for financial services, said Dr Breuer - "it is not popular to say so, but it is true."

The fourth megatrend was the deconstruction of the value chain. Outsourcing was not a remedy for everything – the financial services industry was too complex to follow the auto industry's example and outsource eighty percent of its processes. Done appropriately, however, it could improve the division of labour, leading to a general improvement of productivity. Standardisation, too, could be valuable, as the example of consumer credit showed: it was now possible to run a "decent banking business" whose lack of human input made it less costly and error-prone, while human resources were redirected to more valuable activities elsewhere.

The downside was the loss of direct control. Some activities could never be outsourced, such as product design. That activities outsourced were low-cost was well understood, but they could be low-quality as well, as some firms had discovered and reversed their experiments with outsourced IT or offshored call centres. Outsourcing was thus a risky strategy, and one to be handled with care.

The fifth megatrend, Dr Breuer said, was regulation. The European financial services industry was becoming increasingly over-regulated and expending enormous resources on compliance. The rules were too detailed, encouraging box-ticking, rather than based on principles; and implementation lacked co-ordination, with multinational banks struggling to comply with multiple local standards. The industry needed to engage with regulators to improve this state of affairs.

As a final point, Dr Breuer pointed out that continental Europe still represented a major opportunity, and one whose size made it perhaps more attractive to gain incremental market share than to strive for dominance in a far-flung emerging market. Dr Breuer said he was

confident that continuing integration would ultimately make it possible for firms to operate across the region from their home bases, creating a single retail market full of wealthy, but probably still unsophisticated customers in need of healthcare and investment solutions.

Overall, the outlook was more than favourable. The business model was changing, but demand was not slowing at all, so financial services remained a growth business. Change had already provided huge opportunities for firms which had positioned themselves appropriately, and more would come as the evolving European marketplace provided opportunities for the industry to both take advantage of and to reduce risks for its customers and the financial system.

## **Sources of Future Valuation Growth**

*John Drzik – Chief Executive Officer, Oliver Wyman*

Mr Drzik noted that the financial services sector had enjoyed strong growth in market value over the past decade. The five hundred big firms included in Oliver Wyman's Shareholder Performance Index (SPI) had grown from total market value of around \$4 TN in 2002 to more than \$10 TN by 2006 – faster than non-financial predictions and faster than the "triple value in a decade" trajectory that Oliver Wyman had predicted.

However, there was still cause for concern. Earnings had grown, but PE multiples had if anything declined slightly, remaining at a 20-30% discount to non-financial companies – representing \$3-4TN of market value. There were several possible reasons for this, including opacity and concern about future credit risk. Despite substantial efforts to improve transparency and communicate the new risk landscape, investors still seemed unwilling to re-rate the industry – "something of a puzzle," Mr Drzik said, given its growth potential and the migration of risk to other parties.

The market had its favourites within the industry, too, with clear groups of winners and losers along various axes. Cost efficiency might be easier to achieve, but revenues are more highly valued: firms with strong revenue growth but poor cost efficiency averaged an SPI score of 150, while with the opposite combination scored only 58. The top quartile, who average 164, had grown revenues by entering new markets, improving the effectiveness of the distribution, innovating in response to demand and allocating capital dynamically according to returns.

Acquisition strategy was another key differentiator. The market continued to prefer organic growth to big-ticket acquisitions, but the strongest performers were companies that melded

strong organic growth with "serial acquisition" – repeatedly buying smaller firms and folding them into a proven infrastructure. Interestingly, the *worst* performers, in shareholder value terms, were those that employed the serial acquisition strategy but had weak organic growth, suggesting the market's dim view of the repeated value destruction implied.

Size was another important issue: the market value of large firms grows only weakly even when their earnings are growing strongly. PE ratios, which favoured super-large cap firms in 2000, now favour mid-caps perhaps reflecting acquisition premiums for these firms at the moment but perhaps also their tendency to be "selective conglomerates" that balance diversification and complexity (as discussed earlier by Dr Garside).

The industry should continue to grow faster than the rest of the economy, said Mr Drzik, since people spend a greater proportion of their income on financial services as their wealth grows. On a global basis, demand would continue to increase in emerging markets, while Continental European markets should also come to resemble those of the US and UK. Most future scenarios were optimistic, but the most promising was "enlightened growth", in which light but effective regulation would enable the industry to grow and to stimulate economic growth. The wild card: private equity, which could through active investment "reshuffle" valuation expectations.

*Professor David Llewellyn – Department of Economics, Loughborough University*

The European banking industry is currently very atomised, said Professor Llewellyn, populated with a large number of small banks of very different types: public, state, co-operative, mutual and private. Nor is there a consistent set of objectives; while some are driven by shareholder value (SHV), others are motivated by amorphous stakeholder value (STV) considerations. Governance, competitive conditions and the strength of market forces vary considerably from country to country, as do the structure of institutions and their relative sizes.

One important structural consequence is the limit placed on return on equity (RoE) by STV institutions, examples of which might be private or state-owned banks. The empirical evidence is that RoE earned by SHV banks is actually suppressed by the presence of STV banks, particularly when the latter hold important market share, thus creating "irrational competition". This was the case until recently in Germany – but the banks there have recently simply *chosen* to increase their RoE and redefined their models accordingly.

This is perhaps in response to global pressures including competition, technology, globalisation, financial innovation, regulation, the influence of capital markets, excess capacity, shareholder activism and the search for efficiencies of scale. What effect will these have? There is likely to be change in the structure of European financial systems, with two notable effects coming into play: the ascendancy of markets and the increasing primacy of shareholder value.

Markets are becoming increasingly important in a number of ways. Deeper markets for primary securitisation allow companies to raise money directly through public debt, rather than loans; secondary securitisation and instruments such as credit default swaps allows banks to trade their risks after the fact. That is both redefining banking and altering the roles of financial players: asset managers are increasing in importance relative to banks. This market-centric approach to credit risk is almost unambiguously a good thing: it increases the efficiency of financial services.

Anglo-Saxon economies favour companies run for shareholders and shareholders alone. Continental European ones tend to favour those run for a variety of stakeholders potentially placing the interests of customers, workers and business partners and society as a whole before those of shareholders. SHV institutions set a target rate of return and adapt the institution to meet it; STV organisations do the opposite.

Global pressures, however, will support the SHV approach, thanks to the mobility of capital, the involvement of activist shareholders, often from international, SHV-oriented backgrounds. The need to compete in terms of global equity market valuations, and the mounting power of the market, will mean that more firms choose, more or less willingly, to embrace SHV – although this will be a major cultural change in many countries.

The strategic implications are threefold. To compete, firms will have to be able to anticipate change; be able to respond quickly; and able to absorb uncertainty in the event that their strategic planning proves ill-founded.

*Thomas Huertas – Director, Wholesale Firms Division, Financial Services Authority*

"Value is in the eye of the beholder," said Mr Huertas; and as well as investors and debt-holders, there is a third beholding party: the regulator, whose perspective is informed by its roles as the lender of last resort and protector of consumers, and expressed through prudential regulation and conduct-of-business regulation, both of which can have major effects on the market value of regulated firms.

Banks are moving a new business model rooted in market-based finance, continued Mr Huertas. Having underwritten and originated loans, they may then reduce their exposure by using credit risk mitigants such as credit derivatives or securitisation. They may seek further to construct efficient portfolios by buying exposure through participations in collateralised debt or loan obligations, or selling credit protection through the derivative market.

In this context, value has two drivers. One is based on market-making, underwriting and distribution, and focuses on transforming what banks originate into products that investors want to buy. The other is based on investment, focusing on building an efficient portfolio that contains the illiquid "risk elements" that the bank has to retain. These drivers tend to be correlated, particularly in times of economic or financial stress, when investors become wary. Thus fees may decline even as the banks' own holdings of assets become increasingly distressed – a

potentially ruinous situation from the perspective of market value. Credit Suisse, for example, lost 70% of its market cap in 2003 when a recession in Central and Eastern Europe led to loan losses and the disappearance of investment banking revenues. This situation is alarming to regulators as well as shareholders.

A regulator, as lender of last resort, is in the position of a debt guarantor, and as such wants to constrain borrowers' abilities to leverage themselves or ignore the need for liquidity. But the regulator is in a superior position, since it has the power to introduce correctives or bar action (such as acquisitions) that may damage solvency. The effects of such intervention protect depositors and policyholders, but offer not "an iota" of protection to shareholders. Investors in the holdings companies of First Executive Life and Barings Bank, for example, lost substantial amounts after the forced sale of their major assets in distressed situations.

Conduct-of-business regulation can also have significant costs; companies that view it as a "cost of doing business" imperil both themselves and their shareholders. The direct costs of regulatory censure (penalties) can be very substantial; still more so the cost of investors' reactions. Bankers Trust, for example, ultimately lost its independence after its cavalier treatment of customers was exposed; Citigroup's string of debacles ultimately led to a freeze on strategic acquisitions and stalling of its share price; and Marsh & McLennan's share price crashed after its bid-rigging and handling of contingent premiums was exposed by regulators.

The moral was that investors should ask how a firm is earning its money. What financial and business risks is it taking? What corners is it cutting? If the answer is "quite a few", Mr Huertas said, "then I would suggest shorting the stock."

Professor William Perraudin – Tanaka Business School, Imperial College London

Professor Perraudin said that his perspective on value growth was very much directed at the question: How will new ways of organising banks and new hedging techniques create value growth? Under Neo-Marxist explanations of the industrial revolution, the way of working is all-important, with industrialisation attributed to how things are organised and activities divided up. Adam Smith made a similar point: the division of labour into a sequence of steps can create substantial value. The ways in which banks are organised has changed dramatically in recent years.

There have been two major, linked changes: the emergence of new specialisations between banks; and the pooling of risk among banks and its transfer out of the banking sector. A retail bank, for example, can now specialise in finding and managing customer relationships without retaining the bulk of their risks. This specialisation and reorganisation would be expected to

create value, which it does; the differences in spreads between funding and lending rates as once-illiquid debt is packaged up and marketed gives rise to enormous arbitrage opportunities.

Yet approaches to bank valuation have hardly changed at all. Banks are generally valued by looking at financial ratios like price-to-dividend or price-to-book, which are necessarily different from those employed for non-financial companies because investments in banks are very difficult to measure. Banks are rich in intangible capital – brand, human capital – and "assets" like client relationships that offer opportunities to earn excess spread. Earnings are in turn very difficult to measure.

Another perspective on a bank is that it the first-loss position on a pool of credit exposures – somewhat like the equity tranche of a collateralised debt obligation. Is there scope to value banks in a similar way to structured credit products? There is an increasingly large and active grey area between structured products and traditional banks, occupied by entities such as Structured Investment Vehicles and Credit Derivative Product Companies. Both are being actively developed by banks and hedge funds: in effect, a parallel banking system is being set up.

How should these products be valued? Should a ratings agency task its bank group or its structured product team with assessing them? The latter are typically rated using simulations models, with the key issues being default correlations, ratings of the underlying assets and excess spread – a completely different approach to first-loss value than the one taken in bank valuation. This approach is bottom-up, rather than top-down. Historically, this bottom-up approach could not have applied to banks, but Basel II has meant the introduction of systematic credit scoring systems and better tools for modelling credit risk.

Who would benefit? Originators, who are the fixed factor in the risk unbundling process; Basel II compliant banks, who have the right tools; and firms that can draw on long credit data histories. Structuring specialists and firms adept at risk transfer should also do well – although the SIVs and CDPCs set up by hedge funds may in due course provide competition for the investment banks. Broadly speaking, firms who embrace the technology will prosper – as will their collaborators.