CHAPTER 1

Why is Value Management Important?

COPYRIGHTED MATERIAL

CFOs and CROs have significant potential to influence the value of their firm through three channels.

- First, by providing *better information* in the form of RAPMs,[1] which link management actions directly to shareholder value.
- Second, by challenging businesses to higher levels of performance through *better insights,* including segment-specific strategies and management actions.
- Third, by taking *better decisions* in their own areas of responsibility, especially corporate strategy, capital allocation, balance sheet management and risk management.

This chapter motivates the importance of these three levers in managing the value of the company from a CFO and CRO's perspective.

BETTER INFORMATION

The first objective of this Handbook is to develop a value and performance measurement framework which can be used by managers at all levels to set strategy and steer risk-based, capital-intensive banking and insurance businesses. The valuation framework, illustrated below, splits the value of the firm between its current net asset value (or the market value of its current assets less its liabilities) and its franchise value (reflecting future, profitable new business).

Figure 1.1 is used throughout the Handbook to represent the three value levers available to CFOs and CROs – better information, better insights and better decisions.

The top part of the figure represents better information in the form of a valuation framework suitable for risk-based, capital-intensive businesses. This framework explicitly links management actions to both traditional value drivers – including profitable growth and operating efficiency – and value drivers unique to banking and insurance – including

[1]Banks and insurers use different risk-adjusted metrics in practice, including RAROC (Risk-Adjusted Return On Capital), RORAC (Return On Risk-Adjusted Capital) and even RARORAC. By definition, not all of them will lead to the "right" answer. This Handbook defines RAPMs consistent with shareholder value.

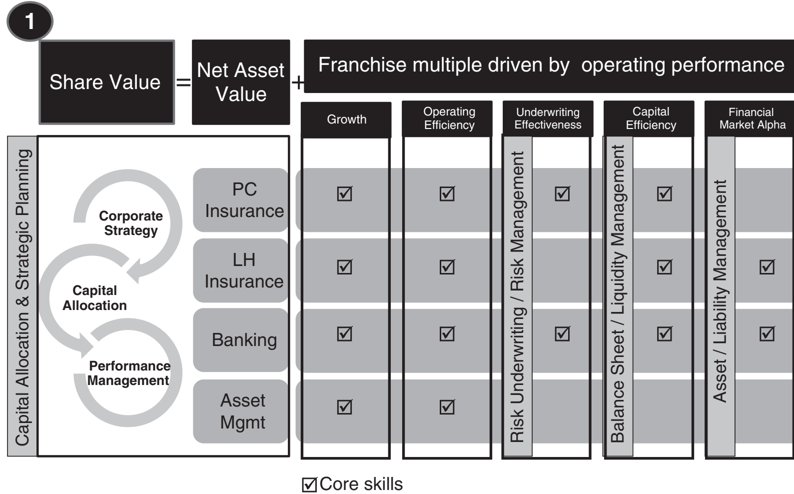

FIGURE 1.1 Better information – What gets measured, gets managed

underwriting effectiveness, capital efficiency and financial returns from asset/liability mismatches. Better information is covered in Part II of the Handbook.

The rows in the figure represent better insights, representing the strategies and core skills needed to create value in each business segment. It suggests, for example, that sales effectiveness and operating efficiency are critical for all segments, but that managing "alpha" through asset/liability management is core only for Life and Health (LH) insurance and banking. Better insights is the theme of Part III of the Handbook.

The columns in the figure represent better decisions taken by the finance and risk functions, focusing on strategic planning and capital allocation; risk management and underwriting; balance sheet and liquidity management; asset/liability management. The topic of better decisions is covered in Part IV of the Handbook.

Why It Is Important

There is an old saying, "What gets measured, gets managed." It is colorfully illustrated by the story of the chandelier factory in the old Soviet Union, where the Party had set production targets in gross tons of chandeliers. What did they get? Consistent with the incentives, the factory produced a dozen chandeliers, each weighing the equivalent of a small bus and capable of pulling down the roof of any building were they ever to be installed. The result: many tons of chandeliers, all twelve of them, but no light.

If we want to manage shareholder value and performance, we first need to measure it. If a company measures performance in terms of market share or sales growth then, guess what, market share and sales growth will be what it gets if successful. But does higher market share or growth create value? Not always. The international expansion of Japanese commercial banks and German Landesbanken in the 1990s illustrates strategies which arguably focused on growth but sacrificed shareholder value.

Similarly, a company focusing on risk-adjusted returns will achieve a higher return on capital if successful. But do higher percentage returns always translate into higher shareholder value? Even if the capital deployed is decreasing? Returns below the cost of capital obviously destroy value, but investing less and less capital at marginally higher risk-adjusted returns also represents an opportunity cost to shareholders.

Growth without adequate returns or risk-adjusted returns without growth. Both are bad strategies. Ultimately, the trade-off between growth, risk and returns needs to be understood and evaluated so that the right path can be taken. Providing clarity is one of the key levers that CFOs and CROs can "pull" to help create value.

Why It Is Challenging

Measuring the performance of financial services firms is inherently difficult given the duration, complexity and risks inherent in their products. How to measure the value created by products with highly uncertain cash flows far into the future? Although the standard corporate finance mantra "Cash is King!" works well for industrial corporations, anyone who has had to wade through the complexities of insurance and bank financial accounts knows how difficult it is to go from financial reporting to cash and from cash to value.

In response, banks and insurers have converged on internal RAPM and Economic Profit (EP) frameworks, which make the returns and risks of very different, highly complex financial businesses directly comparable. Unfortunately, RAPM frameworks can be complex, reflecting the complexity of the business, and in spite of the complexity, not all of them provide the "right" answer.

In addition, the inherent complexity can make the link between RAPMs and shareholder value seem so tenuous to senior managers that they revert to a simpler paradigm to manage value – one of accounting earnings, earnings growth and P/E (price/earnings) multiples – even though, by ignoring capital and risk, the simpler approaches will lead almost certainly to the wrong decisions.

I remember a conversation that I had with the CFO of a large bank in North America while conducting a survey on the role of the CFO and CRO (OWC, 2003). We quickly established that the bank used RAROC to evaluate individual credits and business unit strategies, that RAROC was accepted by management and used to set targets and incentivize performance.

"At last!" I thought to myself. "Here is the poster child for value management that I have been searching for!" And so, with growing enthusiasm and great expectations, I (naively) asked my final question of the interview, "So, RAROC has had a strong influence in terms of shaping your corporate strategy?"

The answer was dumbfounding: "Shaping corporate strategy? But why? The CEO and I drive strategy by looking at earnings, earnings growth and a P/E multiple – from a shareholders' perspective, isn't that all that we need to set the strategy of the bank?"

A lot of questions ran through my head: If the bank's internal metrics don't link to value and are not used to set corporate strategy, then why go through the effort? Looking at it from another angle, if P/E or M/B (market-to-book) ratios accurately reflect value, then what determines them? Why do some firms enjoy an M/B multiple of 2× tangible equity and others only 1× or less? And finally, isn't ignoring risk and capital, as P/E and M/B multiples seem to do, asking for trouble when managing risk-based, capital-intensive businesses?

During the remaining interviews, I asked the same question of other CFOs and CROs. A consistent picture emerged: even in the most "advanced" institutions, senior management

relied more on a combination of revenue and earnings growth and market multiples to set strategy, ignoring internal performance metrics which were developed over many years and with great effort. This is not to say that RAPMs and EP didn't have an impact at the tactical and transaction level, just that they more often failed to impact the strategy of the firm.

The reasons cited most often were the complexity of the internal metrics, combined with lingering concerns regarding stability and accuracy. From my experience, however, the real issue was simpler: most CEOs, business unit heads and CFOs saw no clear link between the complex internal metrics and the external valuation multiples used in practice. During my career, I have seen more CEOs sketch their corporate strategy on the "back of an envelope" for equity analysts using P/E multiples than I have seen using RAPMs and EP!

Fortunately, there is a way to salvage RAPM frameworks, correcting the flaws and allowing them to be understood and more closely aligned with value creation. These are the themes developed in the more technical Part II of this Handbook.

BETTER INSIGHTS

Better information is necessary but not sufficient; ultimately, strategic and operational decisions have to be taken, including the allocation of capital, and this requires an in-depth understanding of the marketplace as well as business strategies, core competencies and management actions which can be implemented. See Figure 1.2.

Why It Is Important

An interview with the CFO of a mid-sized European bank illustrated the importance of better insights in terms of both business challenge and capital allocation. Like many of his peers, the

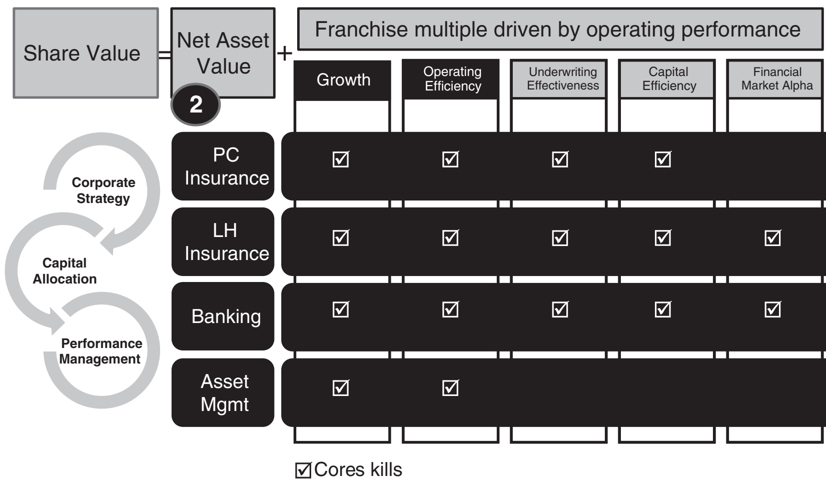

FIGURE 1.2 Better insights

CFO's role had evolved over time from the Head of Accounting and Reporting to a modern CFO, including responsibility for the strategic planning process.

Focusing on strategic planning, he explained the steps already taken in supplementing accounting information with an economic value framework and moving from a bottom-up, revenue- and expense-budgeting exercise to a process emphasizing strategy.

Even with this progress, the results were unsatisfactory: the plans, derived bottom-up, were anything but "strategic," being better characterized as "business as usual" or "last year plus 5%."

The firm had more than adequate information and a clearly defined planning process supported by extensive Gantt charts,[2] taking up significant resources and delivering a bulky end product. In spite of these, the CFO and CEO were left feeling that the company was missing opportunities which would have required a more fundamental rethink of where capital was allocated and that the business units should have – and could have – committed to much more in terms of results and tangible actions to address the real issues. Unfortunately, these commitments were simply not forthcoming and the businesses were allowed to grow, and capital was allocated, based on momentum and not on their potential.

This was frustrating, because the CFO and CEO (as well as the market!) knew that competitors were more aggressively re-dimensioning their commercial loan portfolio, building more profitable private client businesses and adjusting their cost base. As a consequence, the bank's share price lagged behind those of its peers, and analysts were playing Monday morning quarterback during every conference call, letting the CFO know what plays they should have run after the fact.

Why It Is Challenging

The portfolio of businesses in a large, diversified financial services firm is increasingly complex and international, limiting the effectiveness of market discipline on capital allocation decisions. The role of market discipline falls naturally on the corporate center, comprising the group's CEO, CFO and CRO: it is the corporate center's responsibility to allocate capital between competing interests and challenge business strategies based on an in-depth understanding of the marketplace, competitors' strategies and relative business performance.

Returning to the interview, the CFO described how, working together with the CEO, they altered the role of the corporate center from that of a "financial investor" (focused on providing capital and consolidated financial reporting) to that of a "private equity firm," focusing relentlessly on value creation through a deeper understanding of the businesses and proactive capital management.

One important step was the creation of an "equity analyst" group within the finance function, which regularly performed a sum-of-parts valuation of the firm, defining and benchmarking key value drivers for each business and evaluating peer strategies. The end result was a clear understanding of which businesses were under- and over-performing and the value of the "performance gaps" in terms of potential share price appreciation.

As he explained it, these insights were fundamental in reshaping the dialog between the corporate center and the business units: during the next planning round it was much easier to set tougher targets, initiate greater change, reallocate capital and ultimately shake the business

[2]A Gantt chart is a type of bar chart used to illustrate a project schedule. It was developed by Henry Gantt in the 1910s.

units out of their strategic inertia, especially in areas where the company was producing bottom quartile results.

The interview reinforced the observation that *better insights* – with respect to markets, competitors and strategies – are critical for the CFO as a value manager.

Part III of this Handbook provides segment-specific insights into business strategies (or "rules of the game"), core competencies and management actions used by successful banks and insurers. It then continues by outlining strategies for profitable growth and operating efficiency applicable to all segments. It is useful for CEOs and business leaders when taking strategic and operational decisions as well as for the finance and risk functions when allocating capital and challenging line managers from a shareholder value perspective.

BETTER DECISIONS

CFOs and CROs also take important decisions in their own areas of responsibility. From a value management perspective, the most important decisions include corporate strategy and capital allocation; balance sheet, liquidity and asset/liability management; as well as underwriting and risk management. The third objective of this Handbook, highlighted in Figure 1.3, is to help CFOs and CROs take decisions in these three important areas.

Corporate Strategy and Capital Allocation: Why It Is Important and Challenging

Capital allocation is the tool used to implement corporate strategy, clearly defining which businesses you will harvest for cash, which you will invest in for profitable growth, which you will fix or exit and how much remaining capital will be returned to shareholders. These are the

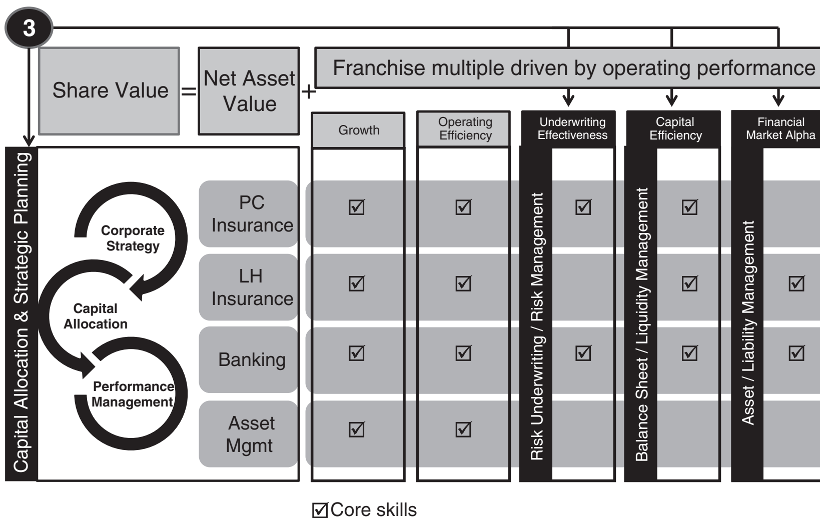

FIGURE 1.3 Better decisions

most important decisions taken at the corporate center from a value management perspective. Getting it wrong represents at best a serious opportunity cost; in the worst case, it can destroy shareholder value.

An Anecdote from Banking

Consider another interview, this time with the CFO of a regional bank in North America. During the meeting, he outlined the corporate goal of doubling the share price in 5 years. Observing that "the P/E multiples for retail and commercial banking are relatively similar," they set the bank's 5-year strategy to invest retained earnings in commercial banking (which was easier to expand organically) at roughly 4× the rate in retail banking (which was more difficult to expand organically). For this company, earnings, earnings growth and the P/E multiple drove the bank's strategy to shift from retail to commercial banking.

Unfortunately, from a shareholder's perspective, the retail bank required significantly less capital per dollar of earnings, offering a 20% RoE (Return on Equity) and an implied M/B valuation multiple of 2× invested capital even without the prospect of significant growth. This was in contrast to the commercial bank, whose 10% RoE only just covered its cost of capital, generating an implied 1× M/B valuation multiple, with or without growth.

While each dollar of earnings from the retail and commercial bank were "worth" about the same based on the segment P/E multiples, the retail bank was throwing off more earnings per unit of invested capital. Given that both businesses required capital to grow, the opportunity cost of the bank's strategy was tremendous: there was an extra dollar of share value foregone for every dollar invested in the commercial bank rather than the retail bank.

An Anecdote from Insurance

LH and Property and Casualty (PC) P/E multiples can also be similar in mature markets. Looking only at P/E multiples, there may have been an historical bias to focus on LH businesses which can grow faster in a bull market, driven by higher account balances and higher investment margins.

This may be the wrong decision, however: even if P/E multiples are comparable, LH RoE and M/B multiples can lag those of a well-run retail PC franchise. The difference is due in part to the higher capital tied up over longer periods to support LH retirement and savings businesses and in part to the quality of earnings, with LH more dependent on investment margins than operating performance.

In 2012, the European LH segment was valued at an average M/B multiple 0.7–0.8× versus 1.2–1.4× for the European PC segment. As Table 1.1 illustrates, the relative differences are consistent independent of whether book value, tangible book value or embedded value is

TABLE 1.1 European Insurance Average Sector Multiples, 2012

Sector* Multiples	PC	LH
Market P/BV	1.12	0.78
Market P/NAV	1.36	0.88
Market P/EV	1.33	0.47

*Own analysis based on JPM 2012 Insurance Sector Report, June
BV = Book Value, NAV = Tangible Net Asset Value
EV = Embedded Value

used in the denominator. (The notable outlier is the price to embedded value for the LH segment; one can only conclude that the industry's embedded values are either naively optimistic or overly aggressive relative to the market's valuation of the business.)

One implication is that there may be an opportunity cost in growing traditional LH at the expense of PC businesses during this period. The second, more disturbing implication is that any incremental growth in LH may actually have been value destroying unless the new business was materially different from the business in force.

The moral of these stories? While growth in earnings may be a Siren's song, one cannot ignore risk and capital when setting strategies and allocating capital for risk-based, capital-intensive businesses.

Balance Sheet Management: Why It Is Important and Challenging

Balance sheet management encompasses three core disciplines, each of which can have a significant impact on value.

- *The capital and financing structure of the firm.* Capital structure and financial leverage directly influence the firm's return on equity and weighted average cost of capital; in addition, operational leverage is key to the banking business model. It is through these channels that the capital financing structure of the firm can influence share valuations.
- *Liquidity management.* The importance of liquidity management is easily illustrated by the list of firms forced into resolution during the 2008 financial crisis due to a lack of liquidity, including for example Bear Stearns, Lehman Brothers, Northern Rock and AIG.
- *Asset/liability management.* Both the banking and insurance industries have suffered spectacular, industry-wide failures due to poor Asset/Liability Management (ALM) decisions. Examples include the US savings and loan crisis in the 1980–90s and the Japanese insurance crisis during the late 1990s, with the current low interest rate environment not boding well for European and other global insurers.

Specifically related to ALM is another interview which I had with the CFO of a large European composite insurance company.

As you may recall, the European insurance industry was hit hard by the equity market correction in 2001–02.[3] The correction had an immediate balance sheet impact for firms heavily exposed to equities, prompting many firms to take drastic action: for example, Aegon, Allianz, Aviva, Hanover Leben, ING, Mannheimer Leben, Munich Re/Ergo, Royal Sun Alliance, Swiss Life, Winterthur, Zurich Financial Services, as well as many others, all did some combination of cutting dividends, recapitalizing the balance sheet, shedding non-core businesses, curtailing growth and radically reducing their risk exposures.

During the course of the interview it became clear that this insurance company had all the outward trappings of "best-in-class" finance and risk management analytics: their risk management function had been measuring and attributing economic capital since before the crisis, including to the equity positions. In addition, the numbers were delivered and accepted by senior management, including the Chief Investment Officer (CIO, who chaired the Asset/Liability Management Committee) and the head of the insurance business who was responsible for product design and pricing.

[3]See Wilson (2003b) and Chapter 16 for more details.

Once again, I ecstatically thought "Here is the poster child for strategic finance and risk: a company which has not only developed advanced risk models to shed light on the true economics of their business, but has also had them accepted by senior management, setting the stage for true impact!"

I was quickly brought back down to earth, however: on my way out the door, the CFO sat at his desk shaking his head and muttered the rhetorical question, "For years, we reported the risk of such a large equity position on our balance sheet and the potential cost of the guarantees – it wasn't as if it was subtle, more like the 900-pound gorilla sitting in the middle of the Board room. We saw the numbers and occasionally talked about the potential impact. Why-oh-why, didn't we *do* anything?"

As the door closed behind me, my last image was of him picking up the phone to his investment banker to arrange a new rights issue or the sale of a non-core business (does it really matter which?) that would stabilize the company's balance sheet and allow it to hobble forward and survive in the aftermath of the 2001–02 crisis.

As I went through the remaining interviews, I noticed a similar trend: "best practice" finance and risk functions in terms of measurement techniques which nonetheless were unable to address the 900-pound gorilla in their Board room. Put another way, even though a company's models and strategic analysis may have correctly identified the issues, many organizations seem incapable of taking the right decisions.

Risk Management: Why It Is Important and Challenging

Financial services create value for shareholders and clients by managing risk, either by underwriting and holding a diversified pool of risks or by intermediating and transforming risks between capital market participants or by providing risk advisory services. It should therefore not come as a surprise that Enterprise Risk Management (ERM) is a cornerstone of creating, and protecting, value in financial services.

With respect to risk underwriting, the cost of risk comprises a significant part of the economics of insurance and banking businesses and a significant source of earnings volatility even during "normal" times. For example, the "cost of risk" can be as high as 60–70% of revenues for a PC insurer as measured by the loss ratio; furthermore, a two to three percentage point variation in the loss ratio can be levered up to a 20–30% impact on operating profit, depending on the company's expense ratio and investment results. Risk has a similarly large impact on the fortunes of banks and LH insurers.

Better risk underwriting can lead to both *higher average* operating earnings and *lower volatility* in earnings. But the profitability advantage from better underwriting is not only defensive: it can also be used to attack the market by identifying niches where more profitable business can be written. In other words, good risk management is not only about applying the brakes; it is also used to give gas and grow profitable business.

"Good" risk decisions balance uncertain rewards potentially far in the future against revenues today. Achieving this balance on an institution-wide scale is challenging for a variety of reasons.

Risk underwriting. First, because it is difficult to accurately identify, assess, price and underwrite risks. The challenges arise frequently due to a lack of adequate data, models or experience or because the environment has changed, implying that the past is not a good indicator of the future. Unfortunately, the challenge just as frequently comes from a fundamental failure in the basic blocking-and-tackling needed to be a world-class underwriter.

Incentives and culture. Second, because it is difficult to align the incentives of those who take the decisions today with the interests of the shareholders, customers and regulators who may have to cover the adverse outcomes in the future. Aligning interests is challenging due to the complexity of the business, management's information advantage on the risks taken and the limited liability nature of managers' contracts, potentially leading to a "heads I win, tails you lose" proposition. Most important, it is impossible to fully align interests using only quantitative mechanisms, implying that risk culture plays an important but unquantifiable role in ERM.

Risk strategy and appetite. Third, because it is challenging to link business and risk strategy, answering fundamental questions such as the following.

- How much exposure to a market do we "need" and how much is "too much?" How high should limits be set during normal times? During bull markets or periods of "irrational exuberance?" Should we be "dancing while the music is playing" or be more prudent, occasionally sitting one out?
- Which risks are necessary for our strategy to create value and which are incidental, to be avoided if possible? Where do we create value by taking risks and where do we simply generate earnings?

WHY SHAREHOLDER VALUE?

In order to be successful in a highly competitive and dynamic environment, value managers need to have better information, better insights and take better decisions. But this presupposes that shareholder value is a key objective of the firm.

I firmly believe that if shareholder value is not your top priority, then it should be. My line of argument is simple: in addition to being in the best interests of shareholders, it is also in the long-run best interests of other stakeholders, including your customers, employees, regulators, society more broadly and even you as a manager of the firm.

Value Management, In the Interests of Shareholders . . .

Financial services represent a tough, competitive arena. Corporate Darwinism suggests that the fittest firms will survive and prosper in a self-reinforcing, virtuous cycle. It also suggests that sudden "mutations" and/or environmental disruptions – such as the rise of the Internet and mobile telephony – can create new opportunities as well as new competitors to threaten even the most successful incumbents. Given increased shareholder activism and the benefits of a higher valuation multiple in terms of making acquisitions both firms and management teams that are not able to successfully adapt are destined to pass by the wayside.

However, this is where the analogy breaks down. Whereas evolution breeds success in incremental changes over eons or through sudden, uncontrolled genetic mutations, the management of a bank or insurer has the capability to consciously redesign, adapt and improve itself.

Top-performing institutions *by definition* excel in the core areas of distribution, operations, underwriting and balance sheet management and allocate capital optimally to current and future profitable growth opportunities. These represent decisions taken, not decisions genetically preordained.

In short, bank and insurance management can influence the destiny of their firm, for good or ill, and a strong focus on shareholder value is a necessity if the firm – and the management team – is to survive in highly competitive and dynamic markets.

. . . And All Other Stakeholders

Focusing on shareholder value may not resonate in today's socially conscious world. Should the focus rest solely on shareholder interests, ignoring the interests of other stakeholders such as customers, employees, regulators and the broader society in which we operate? Isn't this too narrow minded? Shouldn't the modern corporation also focus on these other stakeholders' interests?

The role of the corporation in society is hotly debated, a debate which I do not want to open up here. Instead, I make a simple assertion: managing for *long-term* shareholder value requires that you consider the interests of *all* stakeholders, including employees, customers, regulators and the broader society. You cannot create shareholder value without selling products and services and you cannot produce and sell products in the long term without providing value to customers and employees, meeting their expectations regarding environmental and social objectives while satisfying the expectations of regulators.

Depending on what side of the debate you sit, this assertion is either "acting responsibly" or "enlightened self-interest." However, it doesn't matter what side of the debate you take, the results are the same – creating long-term, sustainable value for shareholders is also in the best interests of customers and employees and other stakeholders.

Allianz practices enlightened self-interest, taking comfort in the fact that our products provide value to our customers and they are designed and underwritten considering our customers' needs and the impact on the environment and society. We also take comfort in offering a fair and competitive wage and working conditions to our employees (all 145,000 of them); in the fact that we are compliant with all regulatory requirements at all times; that we support the broader society through other means, such as Allianz4Good, Finance Coach, etc.; that the taxes we pay represent a significant contribution to support other social objectives in the countries that we operate.

This enlightened view is also clearly reflected in the disclosures at our 2014 Annual General Meeting, explaining that in 2013 Allianz distributed €93 bn to clients, indemnifying them against the damages of floods and hailstorms and providing income in retirement, €12 bn to employees, €12 bn to distributers, €3 bn to governments in the form of taxes and €2 bn to shareholders in the form of dividends. In parallel, Allianz has been continuously included in the Dow Jones Sustainability Index (DJSI) since 2000 and in the "FTSE4Good" Sustainability Index since 2001; we also received the "Industry Leader and Gold Class Sustainability Award" in 2014.

Returning to the economic Darwinism analogy, Allianz could not create this value – value to customers, to employees, to society and to shareholders – unless we were in business, and remaining in business in such a competitive arena requires a continual focus on long-term value creation.