

From Strategy to Action: Value Based Management in Banking

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Introduction

The current state of financial market is a powerful reminder not to neglect the risk/capital component of Value Based Management (VBM)

- How to implement Value Based Management?
- What are the value drivers, specific to the industry and the business model?
- What are the generic dimensions along which value can be created?
- How to develop early warning systems?
- How to ensure value is created in the long run?

Agenda

- The evolution of VBM
- Value drivers of the CS Corporate and Retail Banking Unit
- VBM processes

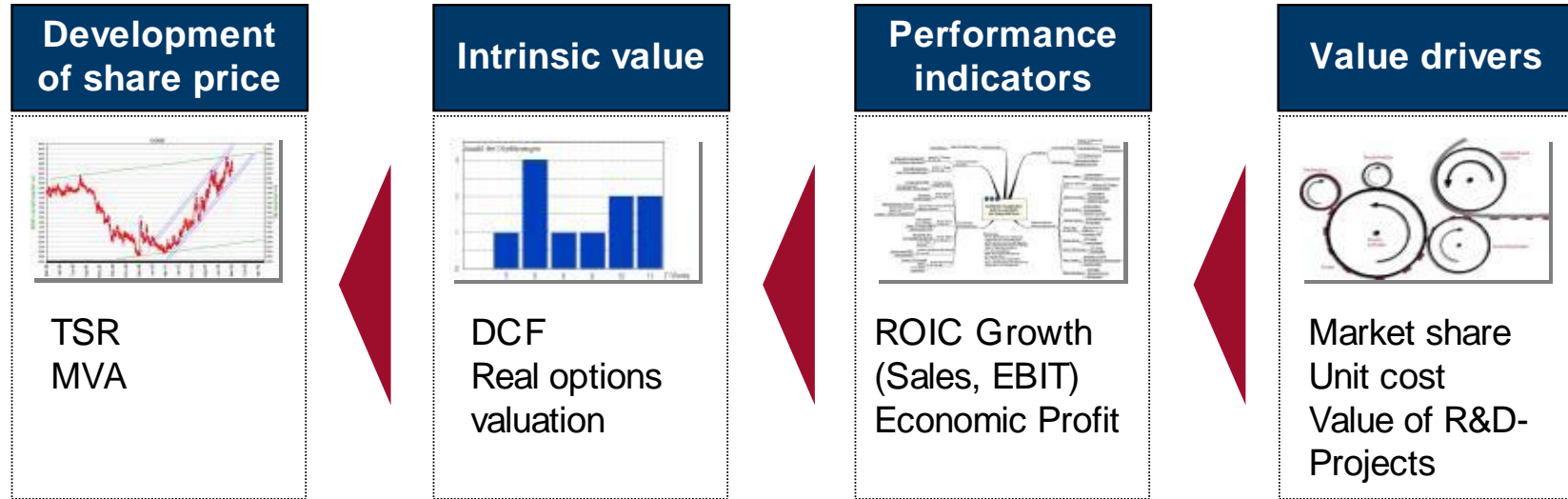
The history of value management theory¹



Capital Asset Pricing Model	Creating Shareholder Value	Managing For Value	Valuation	The Quest For Value	Value Based Management
Sharpe	A. Rappaport	B. Reimann	T. Copeland	G. B. Stewart	e.g. Marakon Assoc.
<ul style="list-style-type: none"> Returns are related to risks incurred by owning a particular financial asset Risk-weighted discount factor to assess the value today of tomorrow's developments, profits & cash flow Introduction of systematic risk factor β (beta) 	<ul style="list-style-type: none"> Introduction of free cash flow model (FCF) Put normal discounted cash flow techniques into a shareholder value (SHV) framework Estimation of the economic value of an investment by discounting forecasted CF by the cost of capital 	<ul style="list-style-type: none"> Link SHV to management approach on how to run a company Widely adapted by management consultants Ideas developed into cash flow return on investment (CFROI) approach 	<ul style="list-style-type: none"> Introduction of comprehensive value-oriented management in order to increase corporate value Exposition of SHV issues and how to deal with them Application of SHV principles is feasible and highly desirable 	<ul style="list-style-type: none"> Introduction of EVA (economic value added) as spread return on capital and cost of capital invested Focused attention on detailed measurement of a company's balance sheet Certain items need different treatment from the way accountants do 	<ul style="list-style-type: none"> Organizing; Analyzing; Managing and Strategizing to deliver Shareholder Value
1950	1970	1980	1987	1990/91	Today

1) In search of shareholder value: Black, Andrew; Wright, Philip; Davies, John

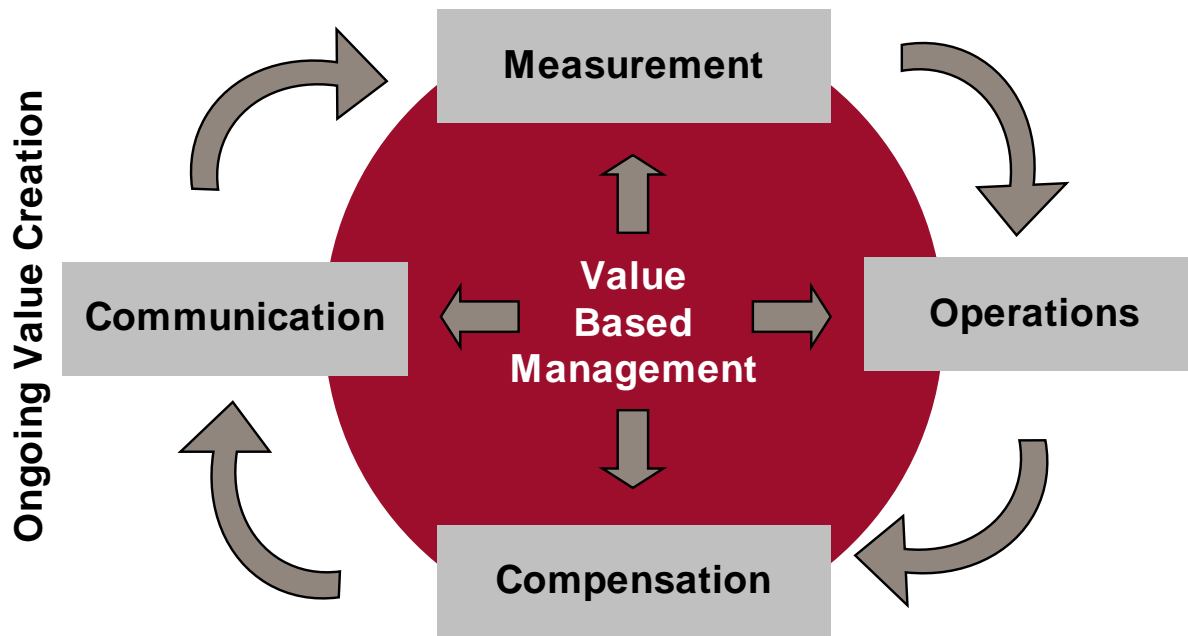
VBM links business strategy and market



- The development of share price as a result-related figure cannot be used alone to make decisions
- The discounted cash flow cannot be used to value past performance
- Short-term oriented financial performance figures announce changes of value development too late - *"if the figures are right today, the future may be lost already"*
- Hence, only monitoring of value drivers avoid the shift from long-term value creation to short-term financial success

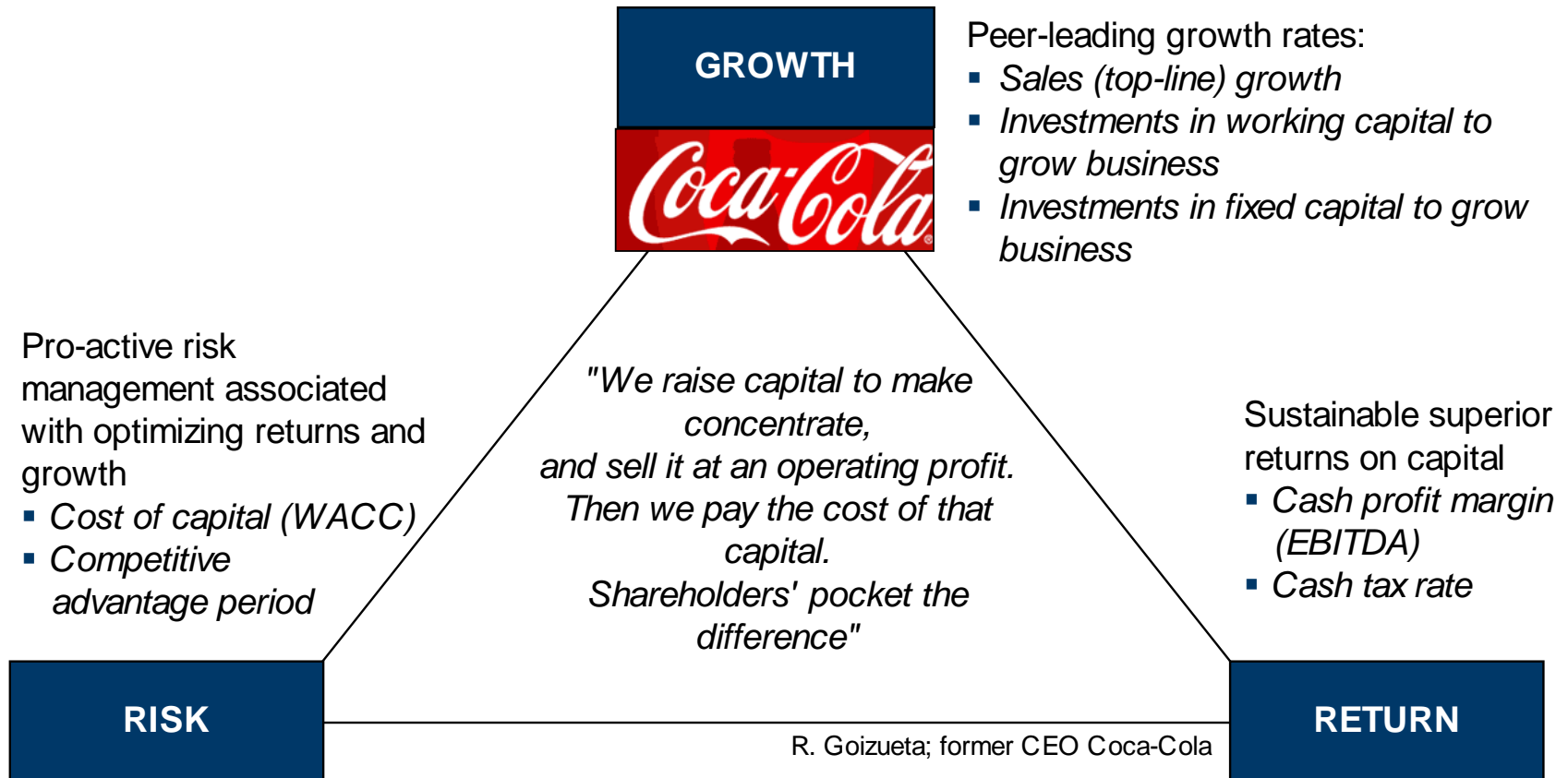
VBM is a comprehensive management approach

Successful value based management leads to a continuously increasing discounted cash flow value recognized by the capital market

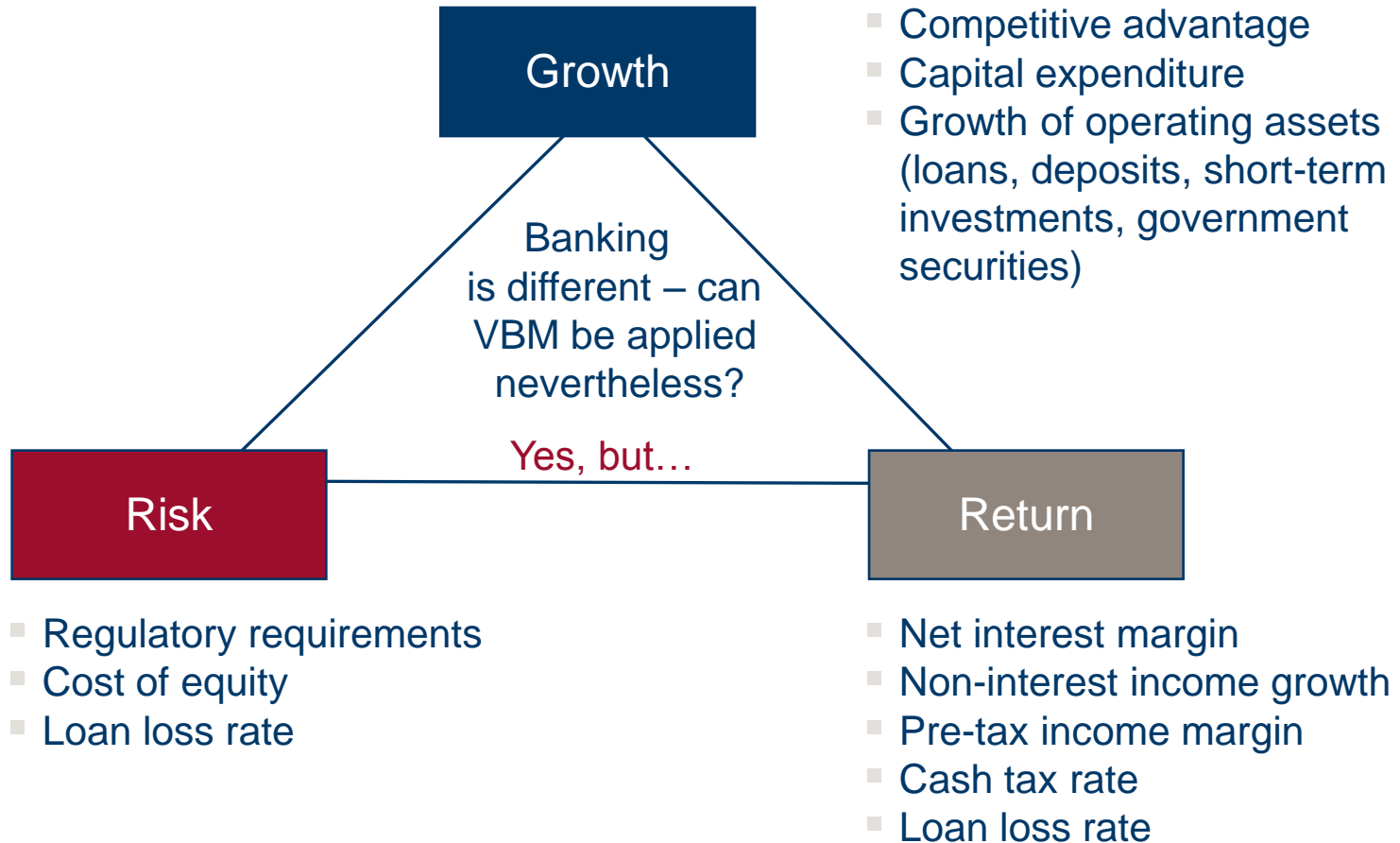


- **Measurement:** Calculation of the fundamental DCF-value
- **Operations:** Connection of planning and reporting
- **Compensation:** Result-based compensation models
- **Communication:** Focused expectation management through active investor relations

Generic value drivers

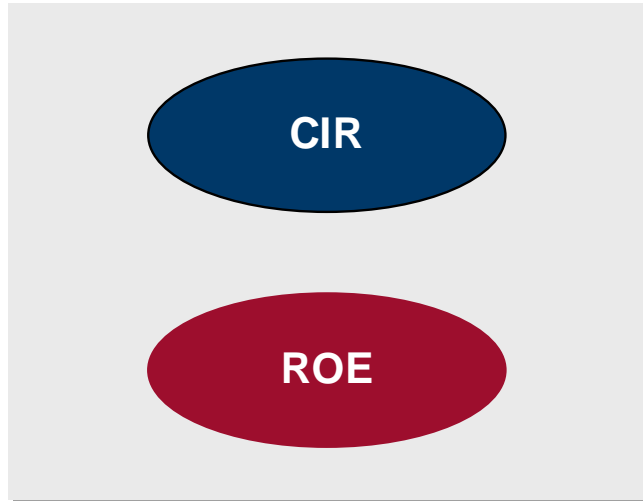


Value drivers in banking



Economic Risk Capital (ERC)

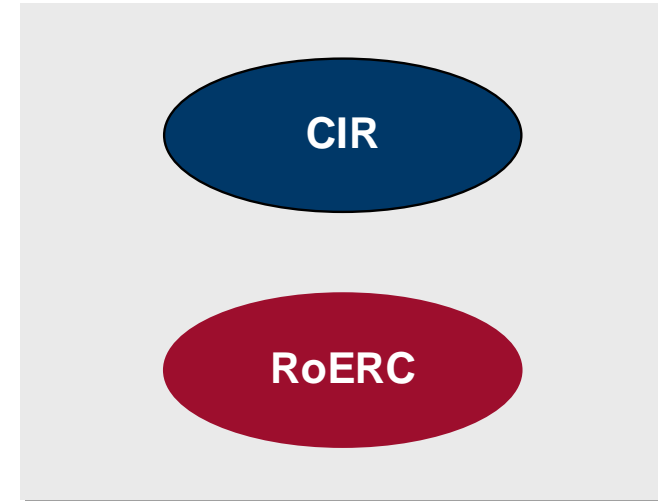
Standard Key Figures



- General key figures to compare banks (standardized calculations)
- However, risk components are not considered explicitly

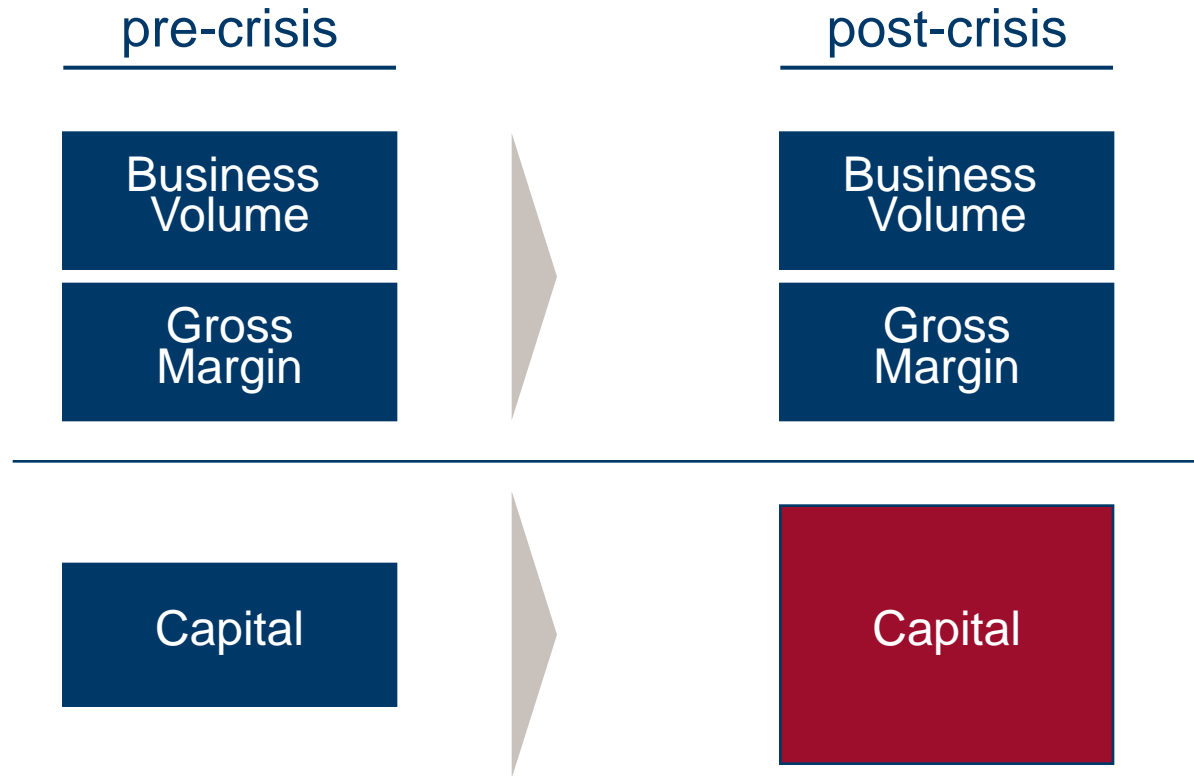


Value-oriented Set of Key Figures



- Attempt to adjust the lack of risk consideration
- However, difficult comparisons due to different calculation standards by each financial institution

VBM and the banking crisis



- Consider capital consumption in addition to volume and margin
- Ensure appropriate measurement of capital consumption

Components of Economic Risk Capital

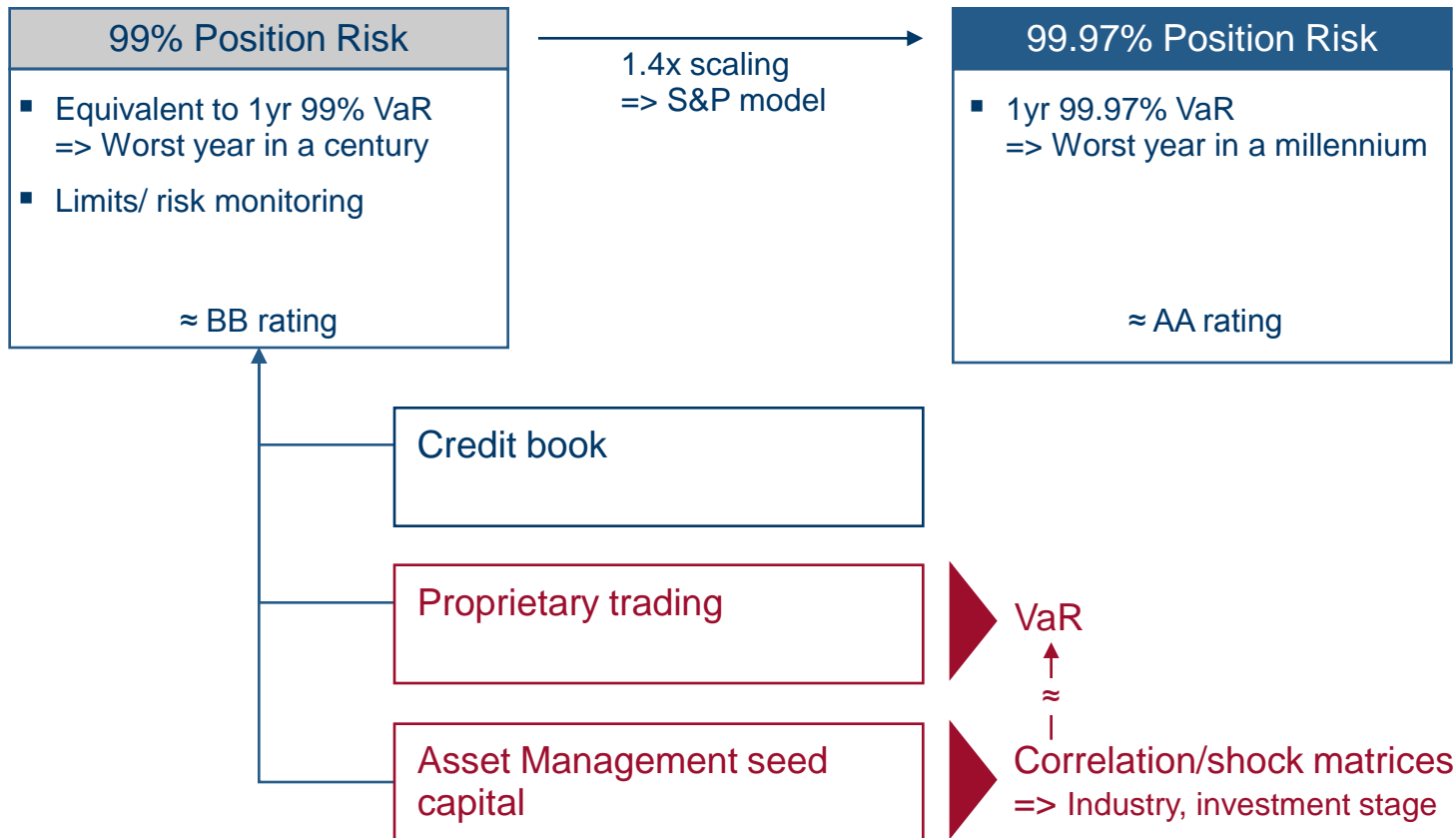
Total ERC

- Best statistical estimate of the economic capital needed to support our business
- Common bank-wide denominator across all risks and businesses



Position Risk

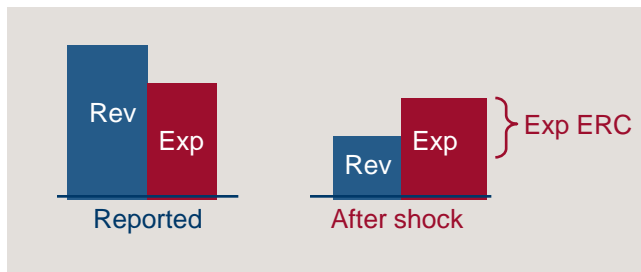
What is the risk inherent in on-balance sheet positions, after diversification?



Expense Risk

Beyond Position Risk, what reserves does it take for a business to survive one particularly bad year?

Shock P/L items



P/L shock	TAM	AI
Fee income	35%	0%
Investment revenue	70%	100%
Bonus	50%	50%
Base expenses	0%	0%

Capital requirement

	P/L after shock	ERC
Business A	-10	10
Business B	8	0
Business C	4	0
AM	2	0

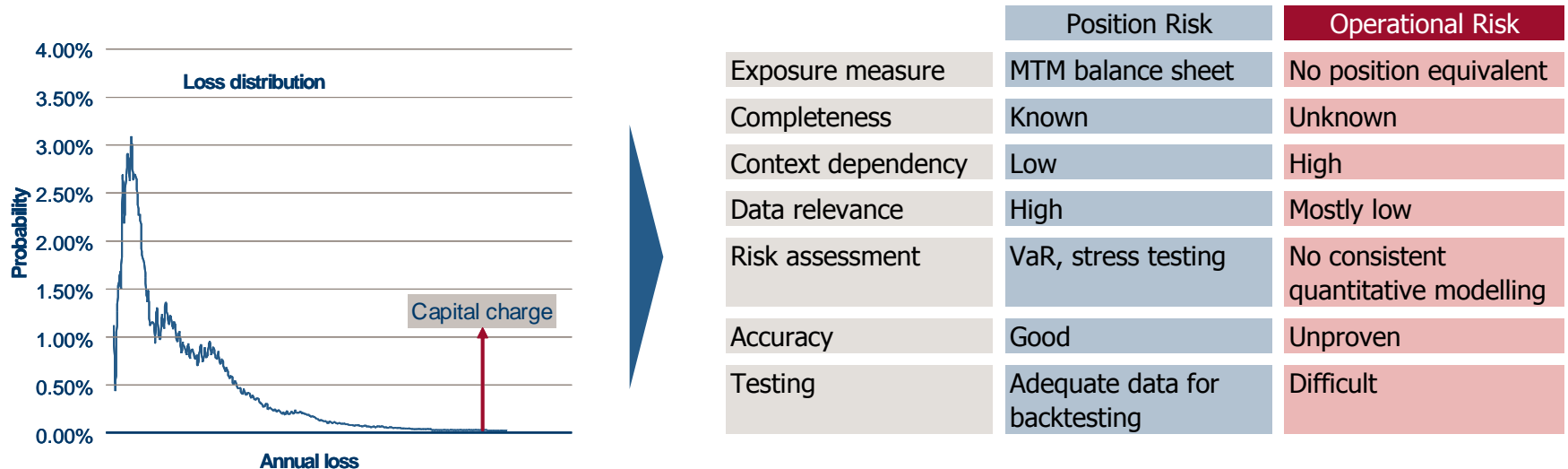
ERC equates to any loss after ...

- the shock
- “cross-subsidies“ between businesses

Operational Risk

The nature of Operational Risk

What is the risk of loss resulting from inadequate internal processes, people or systems or from external events?



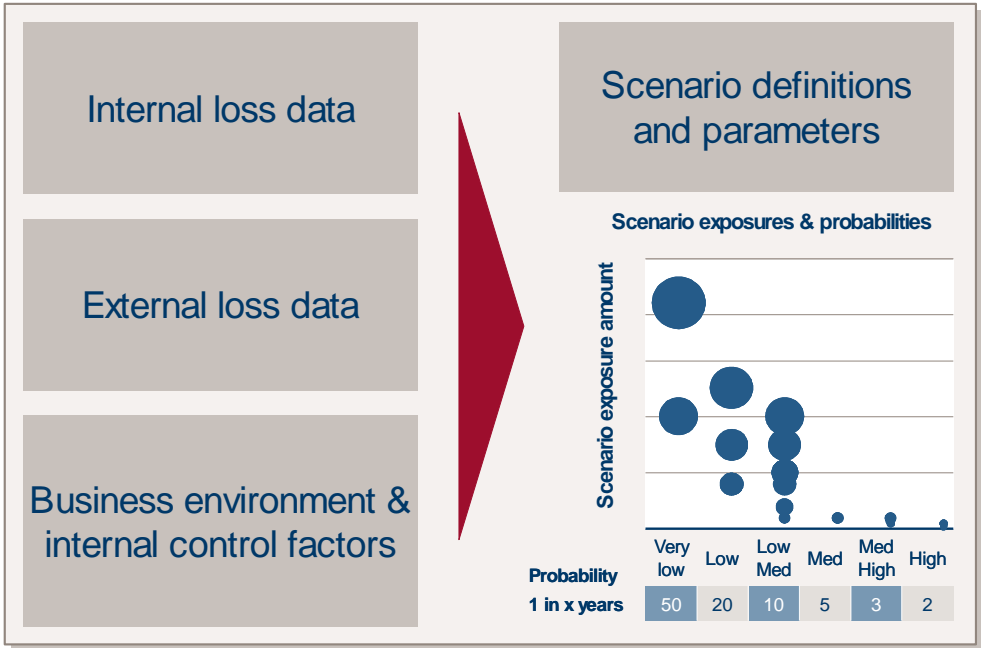
- Relevant events are infrequent
- Operational Risk is hard to quantify

Operational Risk

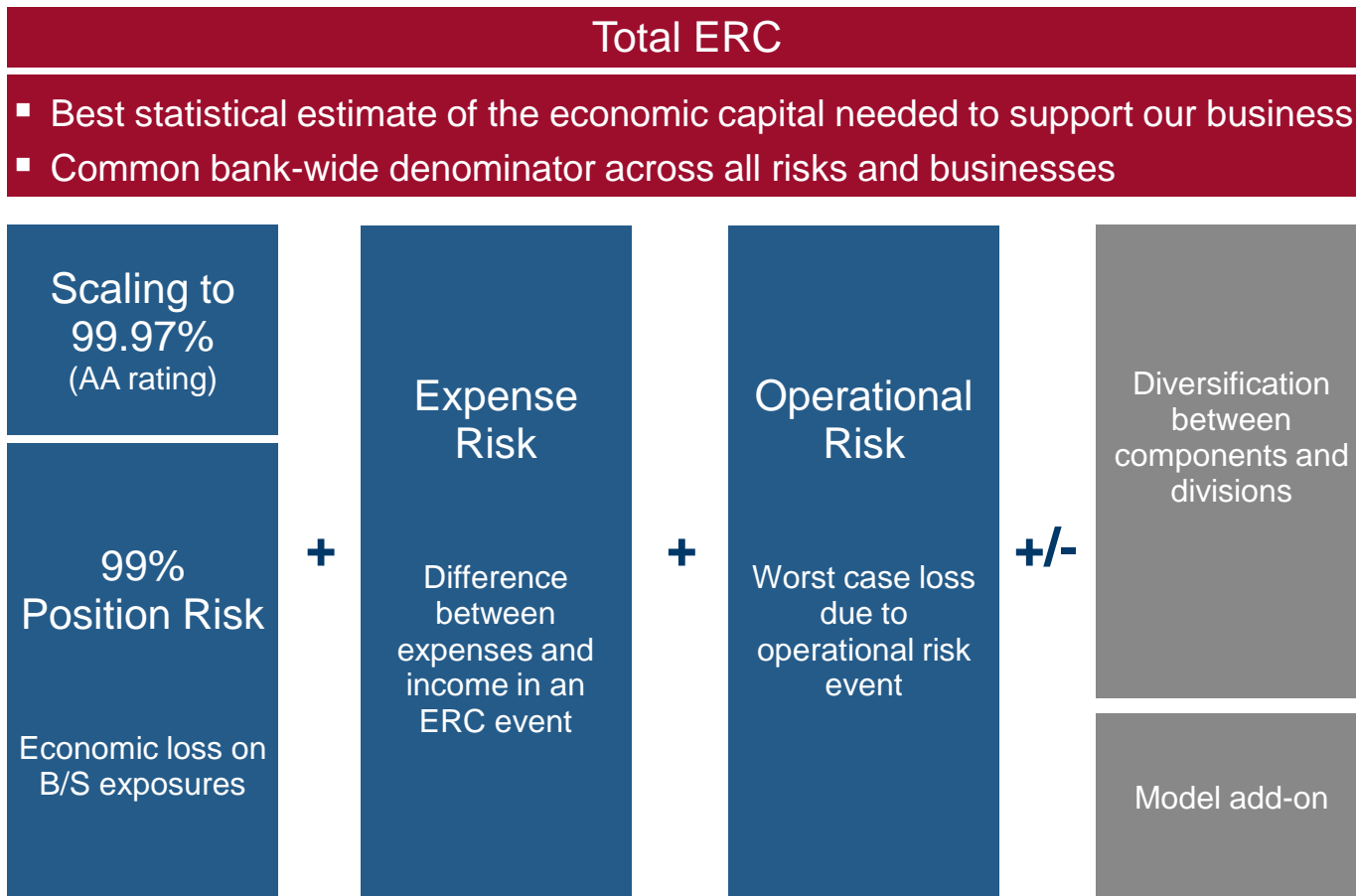
Semi-qualitative approach: divisional and One Bank scenarios



- Business disruption
- Unauthorized activity
- Execution and process management
- Valuation and accounting issues



Wrap-up ERC components



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5 steps to VBM

Step 1

Identify value based figure set

Definition of key figures

Step 2

Build up an appropriate business structure

Definition of businesses

Step 3

Define value drivers of every business

Definition of value driver tree

Step 4

Connect the strategic line items with the value driver tree

Setup of value driver model

Step 5

Integrate the value driver model into the SBP & mgmt process

Anchorage of value driver model

The integrated value concept of the CS Corporate and Retail Banking Unit

Value drivers according to literature

Strategic value drivers	Competitive advantage
	Risk Management
	Flexibility
	...
Financial value drivers	Grow volume & sales
	Cash flow margin
	Profitability
	Investments
	Tax rate
	Working Capital
	Cost of capital
Operational value drivers	• Sales
	• Pricing model
	• Product mix
	• Productivity
	• Overhead costs
	• No. employees
	• Production
	• Working plan
	• Capacity
	• Sales terms
	• Purchase terms
	• Payment terms
	• Supplier strategy
	• Location decision
• Budgeting	
• Innovations	
• Investment decisions	
• Etc.	

5 Value Drivers in CRB



Grow Business Volumes



Increase Profitability & Efficiency



Optimize Risk



Leverage Capital



Build Competitive Advantage

Value drivers at CREDIT SUISSE (1/2)



Increase Profitability (e.g. margin)

- Structured financing and investment products (Capital protection products provide best margins under current market circumstances)
- Intensified relationship management
- Strict risk-adjusted pricing
- Optimized asset and liability management



Increase Efficiency

- Align IT department to respond proactively to internal clients' needs
- Align mid and front office processes
- Decrease back-to-front ratio
- Limit application development to the necessary



Expand Business Volumes

- Strongly influenced by GDP growth
- Mobilize employees: Strictly connect incentive schemes to sales performance
- Massively rising client contact time
- Investing massively in intensified training of relationship managers

Value drivers at CREDIT SUISSE (2/2)



Optimize Risk

- Improve risk assessment and risk management capabilities
- Ensure active portfolio management to maximize RoERC



Leverage Capital

- Implement management of RoERC to connect strategic decisions with RoERC considerations
- Ensure cross-selling to limit dependency on capital intensive businesses
- Implement focused revenue growth strategies



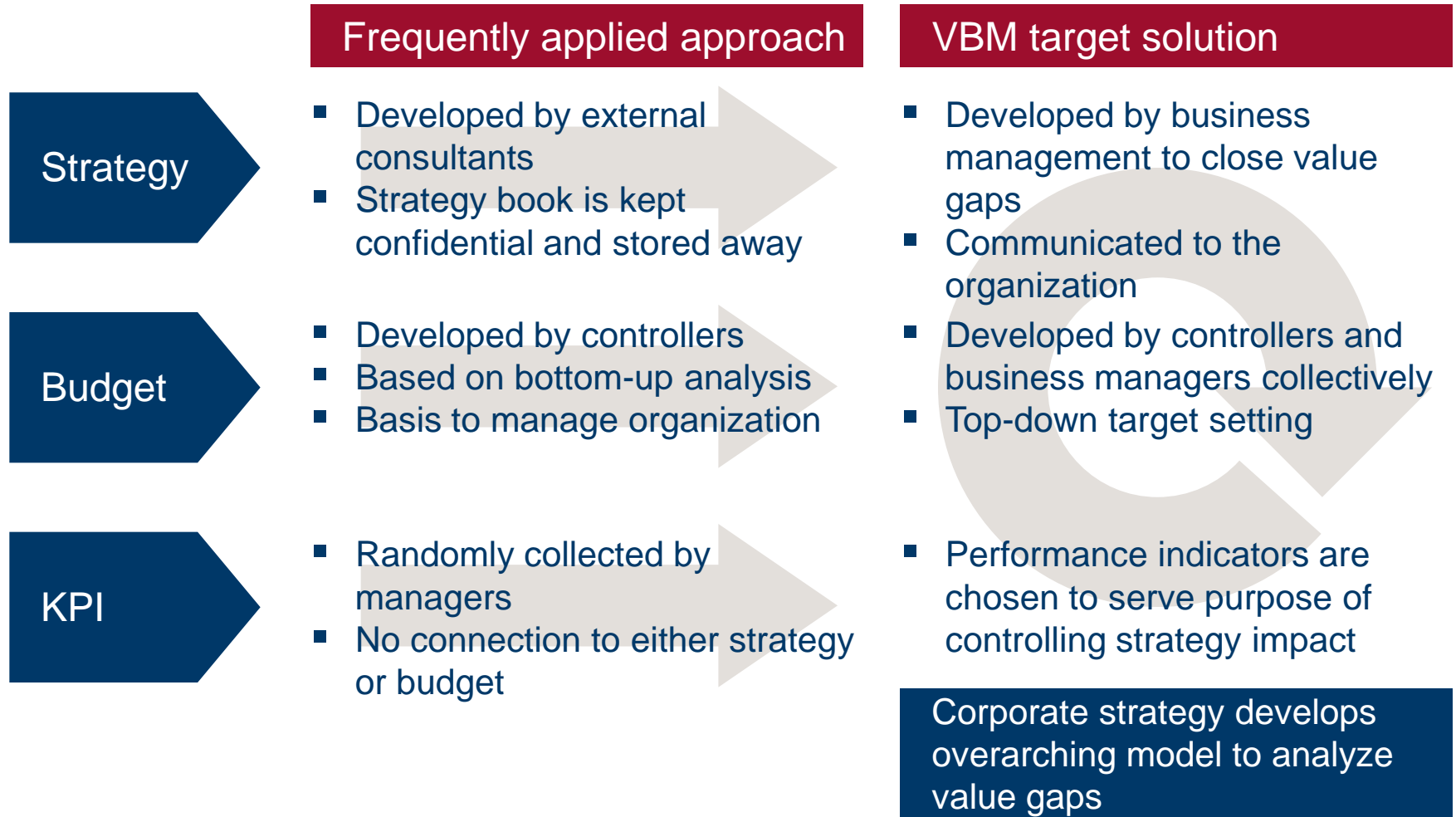
Build Competitive Advantages

- Invest in people and education
- Invest in new businesses, products and markets
- Ensure effective innovation processes

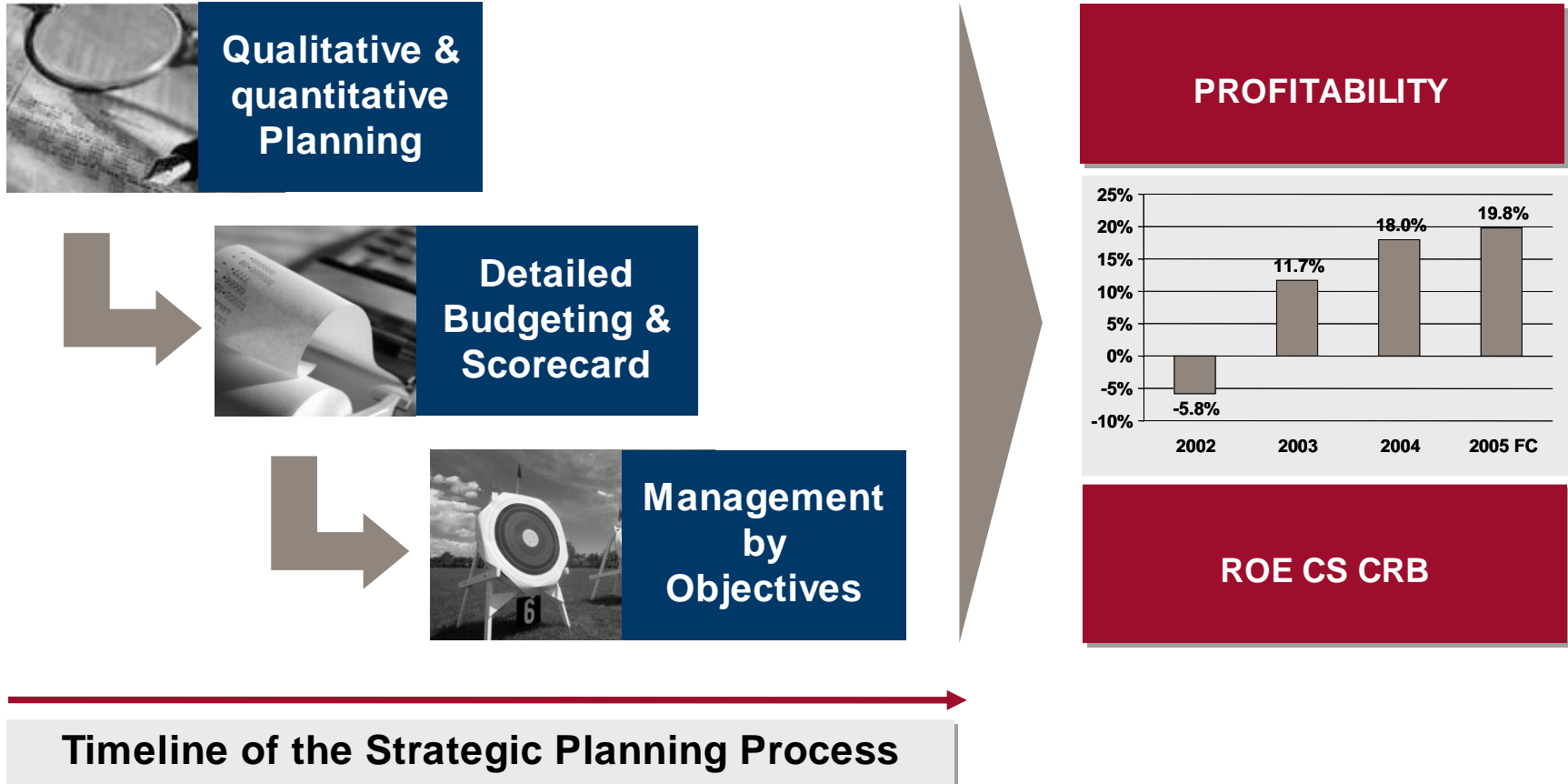
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Introduction to VBM: business planning under the aspect of value generation



Strict top down planning is key¹



1) FC 2005 based on annualized YTD Q3 2005 data

Qualitative and quantitative planning¹

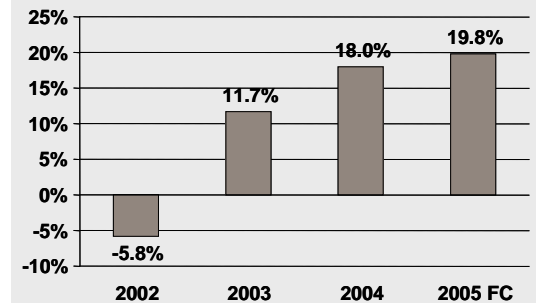


Qualitative & quantitative Planning

- Vision per business
- Qualitative benchmarking
- Financial benchmarking
- Strategic directions & projects
- Financial targets per business unit
 - Target P&L and strategic line items
 - Measures and measure-linked indicators



PROFITABILITY



ROE CS CRB

Timeline of the Strategic Planning Process

¹) FC 2005 based on annualized YTD Q3 2005 data

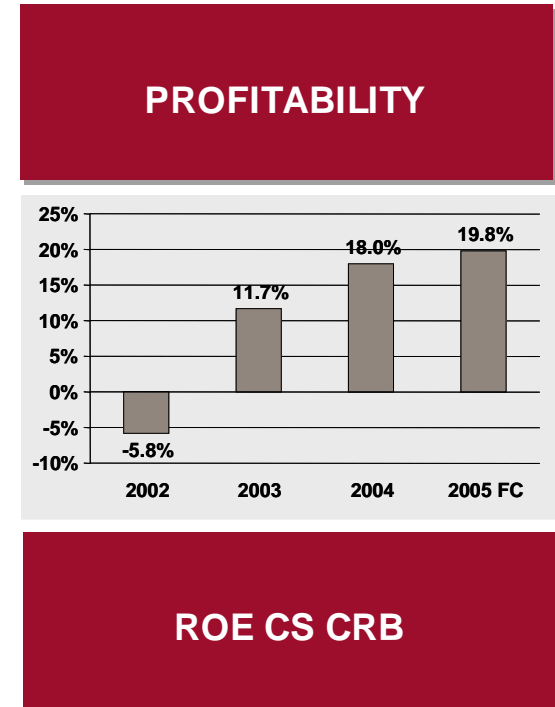
Detailed budgeting and scorecard¹

- Continuity and consistency provides comparability
- Strict coordination prevents and avoids duplication
- Strict guidelines ensure compliance with timeline



- Clear top-down communication
- Detailed budgeting leads to focused cooperation and overall agreed targets

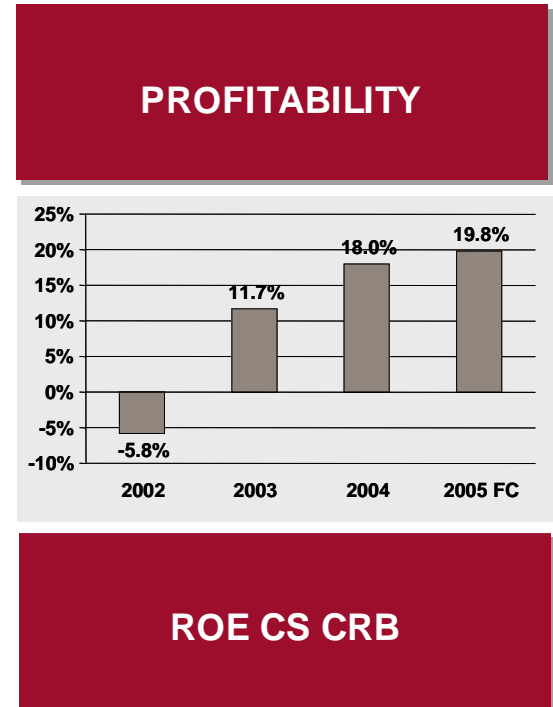
Timeline of the Strategic Planning Process



1) FC 2005 based on annualized YTD Q3 2005 data

Management by objectives¹

- Target setting per individual
- Close guidance of all employees
- Motivation by economic incentives
- Performance control and measurement
- Lessons learned, deviation analysis
- Reward and remuneration



Timeline of the Strategic Planning Process

1) FC 2005 based on annualized YTD Q3 2005 data

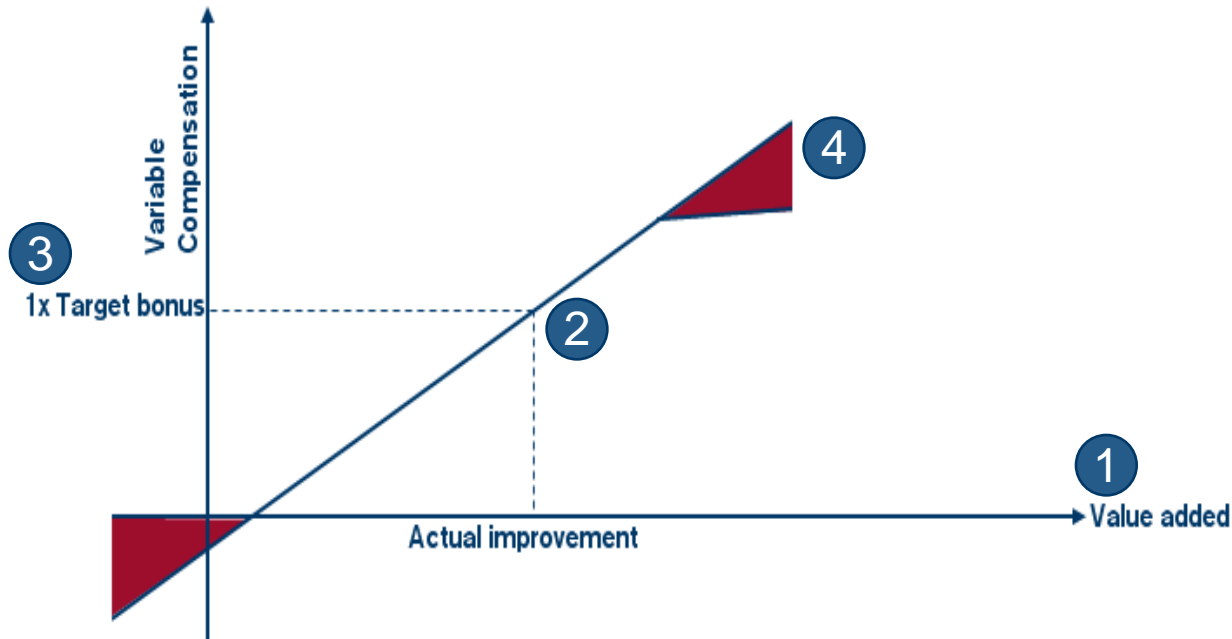
Benefits of the value driver model for the strategic planning process

- Qualitative and quantitative assumptions can be incorporated easily in the model
- The financial effects of planned assumptions are immediately visible in the P&L
- The model focuses the strategic discussions on subjects with strategic relevance
- The planning time of the business units and the division can be shortened significantly

- Focus strategic discussions on value creation
- Increase the quality of strategic decisions
- Increase the efficiency of the strategic planning process
- Consistent link of strategic thrusts (key initiatives) with quantitative objectives
- If – effectively implemented – VBM enables a powerful strategic and operational controlling throughout the year

Value based incentive systems

Foster sustainable value creation through a multi-period model based on capital market expectations and a VBM profit measure



- 1 Use VBM KPI, e.g. EVA
- 2 Compare performance vs. prior period actuals rather than budget
- 3 Consider capital market expectations
- 4 Two-step bonus process
-Contribution of current period
-Bonus bank draw-down or "deposit"

▶ Likewise, overcome the volatility incentives of stock options with share-based compensation

Source: Stern Stewart & Co.