

## Cashflow situation - why to optimise?

In a low interest environment the ability of self-financing only seems to be of no value

*sustainable low interest rates caused by high liquidity mean decreasing elasticity of interest rate adjustment*

increasing volatility would amplify the adverse effect of rising interest rates. Hold cash - directly or indirectly through blue chips !

*savings focussed companies*

high, but falling operating cashflow margin with increasing volatility  
return to growth thanks to demographic bubble and privatisation of pension schemes  
globalisation and cost leadership are the pre-dominant strategies; little room for niche players  
**beware of companies with low operating cashflow - narrow interest margin, low provisioning**

*options focussed companies*

low, but rising operating cashflow margin with high volatility  
increasing natural catastrophe damages and growing investment spending of emerging economies  
fragmentation and differentiation are the pre-dominant strategies; plenty of scope for niche players  
**beware of companies with standard products - private loans, motor**

*financial conglomerates*

high operating cashflow margin with low volatility  
suppliers' trend towards demand orientation in an overall strongly growing financial services market  
globalisation and differentiation are the pre-dominant strategies  
**beware of mid-sized and small conglomerates - weak home-base, lack of experience abroad**

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## **Deregulation takes the financial services industry back to its beginnings**

*Thesis No.*

- 1** In a pragmatic approach one could describe integrated financial servicing as the process of overcoming the branch separation again, which was legally introduced and promoted in the twentieth century, e.g. building societies or health insurance.

A myriad of definitions currently used suggest to adopt a narrow version, which is focussed on the most important partition in the financial industry: the separation between banks and insurances.

- 2** Ahead of the pack ING is perceived as the ground-breaker for successfully integrating banking and insurance business. An also run certainly is the Fortis Group. Both have their roots in world trade nations.

Credit Suisse complements its asset management activities with know how in liability management (co-operating with Swiss Re, Lukas Muehleemann joining the board), having added now direct insurance operations (Winterthur) to its banking business. Allianz Holding adds asset management to its re-insurance business and "co-operates" in banking.

- 3 Inhouse asset management and inhouse re-insurance or investment banking (liability management) can be seen as holding functions. Both functions are indispensable for a smooth cashflow management in the Group.
- 4 How can one identify the benefits of the differing strategies pursued by such conglomerates and measure them ?

The best way to compare very different businesses is to reduce them to a common denominator.

For analysing you should start re-defining the product range using the following categories as common denominators of segments: "savings" (depository business, life assurance), "options" (lending business, non-life insurance) and, if appropriate "investments" (asset management).

***For valuing financial conglomerates cashflows appear useful as a common denominator.***

Thesis No.

- 5 Both, banks and insurers are afraid of increasing positive correlation of risks in their portfolios (options) as well as of an accumulation. Problems arise in particular from a rising synchronisation of markets world-wide and their inter-connection but also from a growing number of population centres. These would post barriers to profitable growth, when a certain scale is reached.

This can be mitigated, when the branch partitions are removed and the internationalisation can be accelerated. For instance, a portfolio could then contain a combination of investment loans to China and motor policies to Italy in spite of these markets probably being highly positively correlated.

Only the loan default or cumulated damage of both policies need to correlate negatively.

- 6 This risk diversification leads to a reduction of risk premia included in the policy/loan rate. The competitive advantage, which financial conglomerates enjoy, is in the "non" correlation of other risks, which will pave way to new economies of scale.

Globalisation and differentiation thus promise excess returns.

The operating cashflow makes a quantum leap in new dimensions: inflow rises, outflow shrinks - *but also vice versa, if it goes wrong* .

- 7 Global asset pooling offers economies and up to an uncertain limit risk diversification.

"Savings" systems, as well as life assurance, bank deposits and other traditional forms, tend to have very similar features around the world. They are rapidly converging to a limited number of basic models that can be offered on a global chassis.

Thesis No.

- 8** The "savings" sector distinguishes two types: own accounts (deposits, traditional life) and third party accounts (funds), with the latter gaining market shares. This in connection with a second trend to more separation and guarantee of customers' money demanded by private and public organizations suggest to treat both types in the same way - as funds.
- 9** To integrate the analysis of life assurance into the "savings" segment, some key variables have to be re-defined: Gross premium income, additional investments into working capital and WACC.
- 10** Strongly falling interest rates can lead to extremely volatile development of market rates. The consequently shrinking interest rate elasticity of the financial company meets a more rate conscious demand. With the result of risk of insolvency increasing.
- 11** Every now and then external shocks hit economies. It is an integrated feature of these events not to be easily predicted, neither their timing nor their nature.

However, it can be predicted with accuracy that such a shock will occur again. The stronger a consensus is, the more likely it is, that already a minor "disappointment", i.e. deviation from expectation suffices to cause a major swing.

- 12** The declining interest margin induces companies to increase their investments in equities. Since at the time short term debt is raised cheaply, the vulnerability to external effects, which are positively correlated, increases: short term rates climb, realised capital gains fall. Only in the long run can higher interest income be generated by the asset side.

There is a growing trend to pass these risks on to the customer, e.g. Fund savings, fund linked insurance policies. This, however, exercises pressure on the cash margin and deteriorates the internal funding ever more. ***Is there a downwards spirale in the "savings" sector ?***

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## The relevant markets - back to savings and options

<u>savings</u> =	<i>borrowing</i> =	<b>paying into an account or deposit against re-payment and interest service</b>
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<u>options</u> = (risks, loans)	<i>lending</i> =	<b>purchasing an option on cash inflow and interest service against paying out the loan amount</b>
	<i>insurance</i> =	<b>selling an option on paying out the claim against a premium paid in</b>

*Specials:*

**investments** =      *asset management* =      **service for commission - in - payment**

Commission income substitutes for shrinking interest surplus at an increasing rate.

**savings/options mix** =      **traditional life or "Kapitallebensversicherung"**

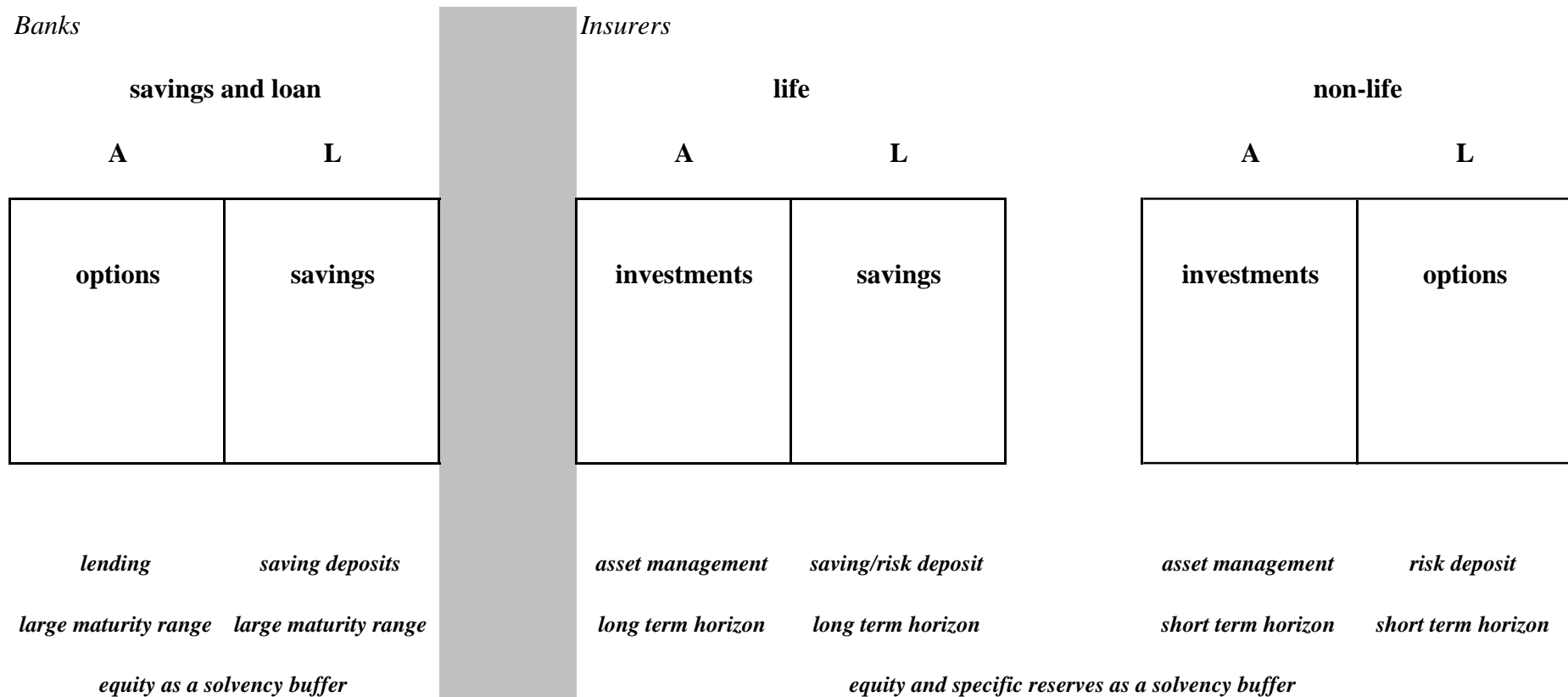
The mixed life insurance sector has become the focal point of criticism. Consumer organisation ask for a clear separation of savings and risk components.

Shareholders' fear for their reserves hidden in the company (see faxes of 13 and 18 February 1998).

There is a strong trend to annuities (in particular against lump sum payments made from the distributions of life policies at maturity), fund linked products and a rising number of single households is seeking for savings vehicles without a term life component.

## Comparing balance sheets of intermediaries

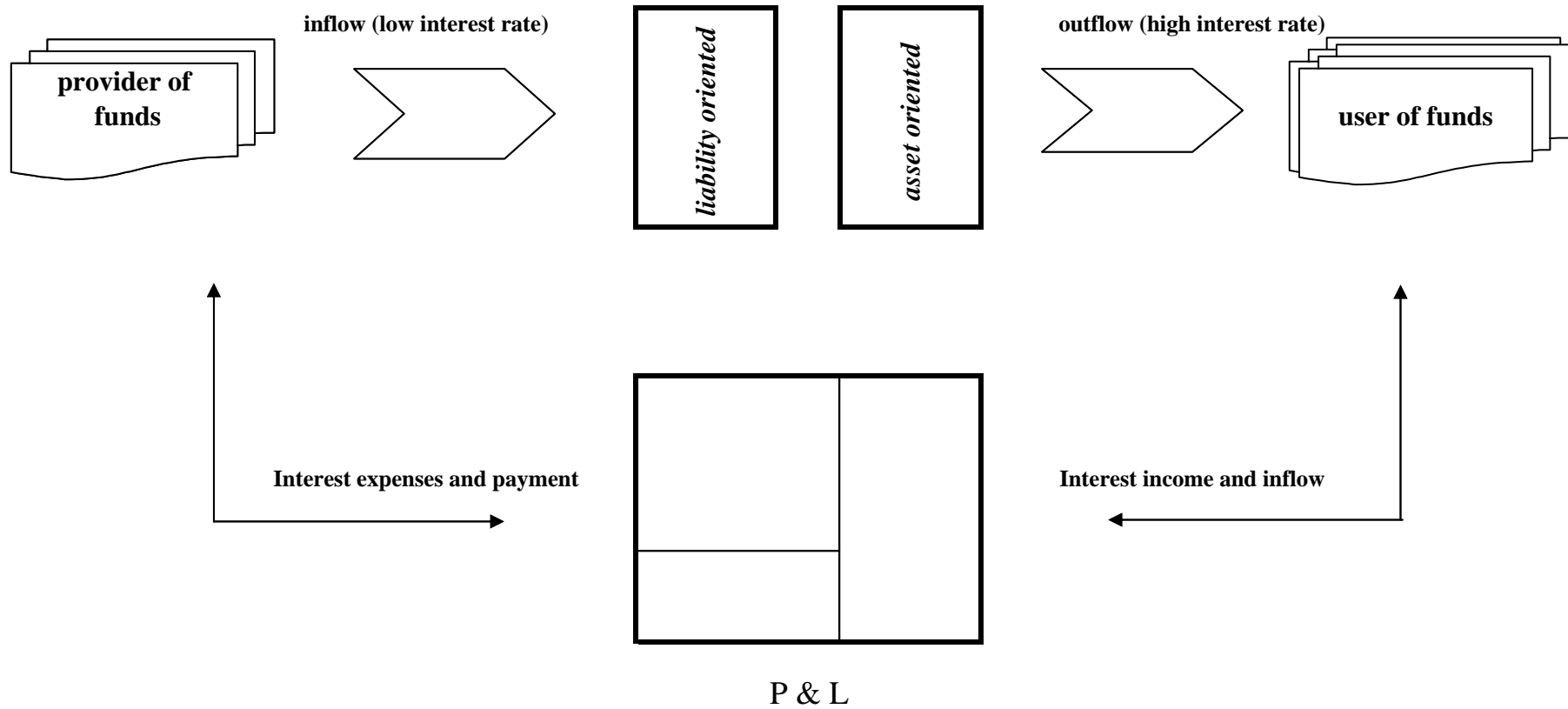
here: focus in asset and liability activities



*The aggregated balance sheet based upon a reformulation of the basic equation relating assets to liabilities: investments = savings.*

## Comparing income statements of intermediaries

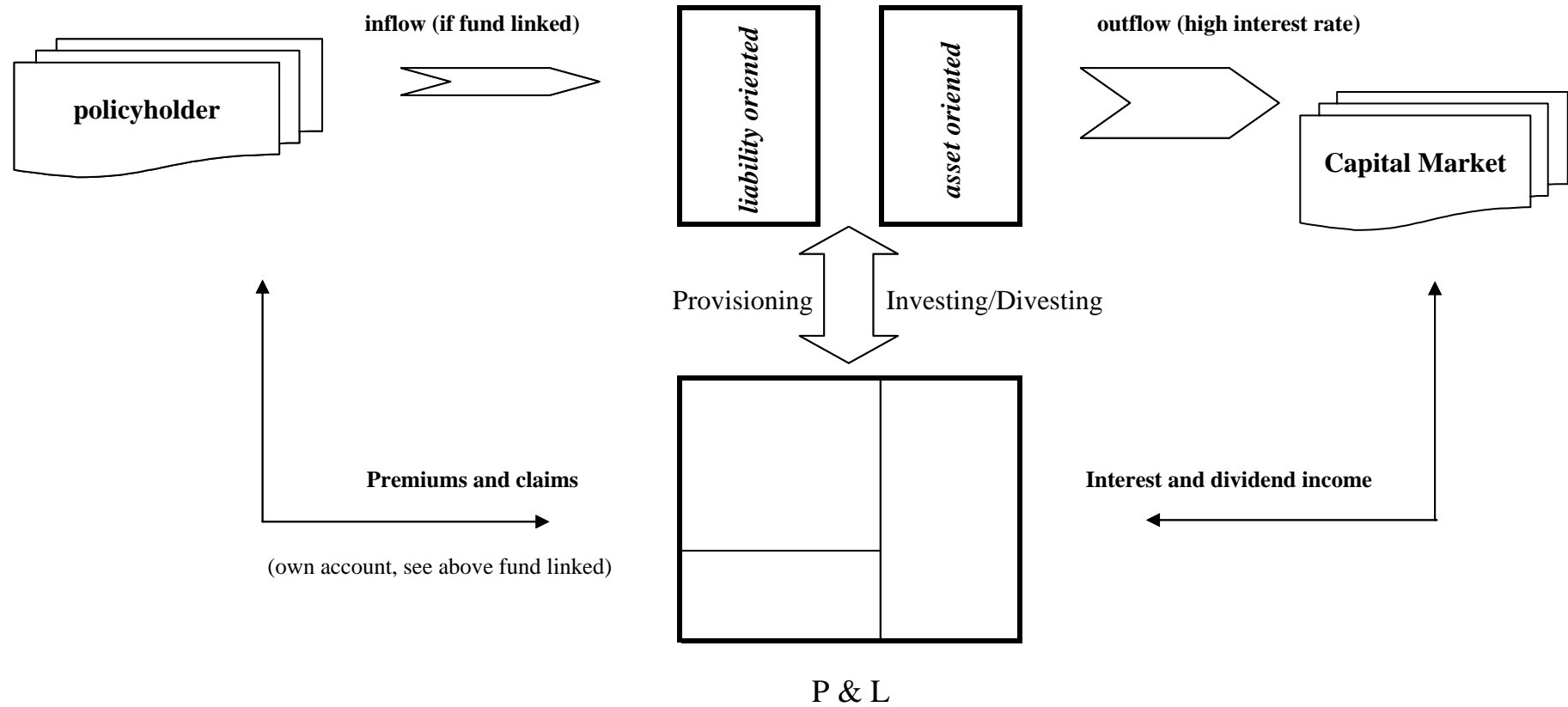
here: banks



*Banks ought to be obliged to provide additional information on net funds flows and debt repayment.*

# Comparing income statements of intermediaries

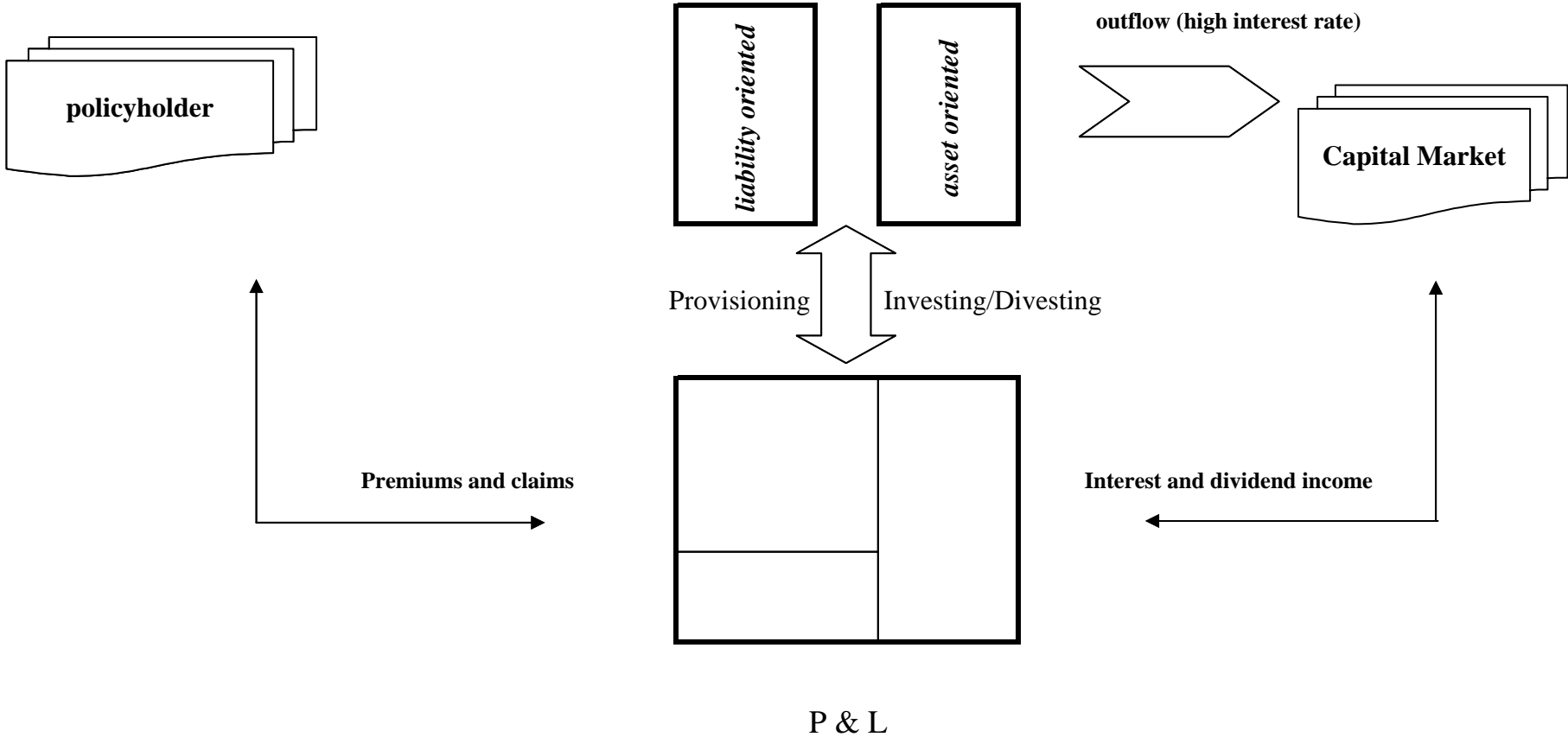
here: life assurance



*Life insurers ought to be forbidden to capitalise premium income for third party business in the P&L.*

# Comparing income statements of intermediaries

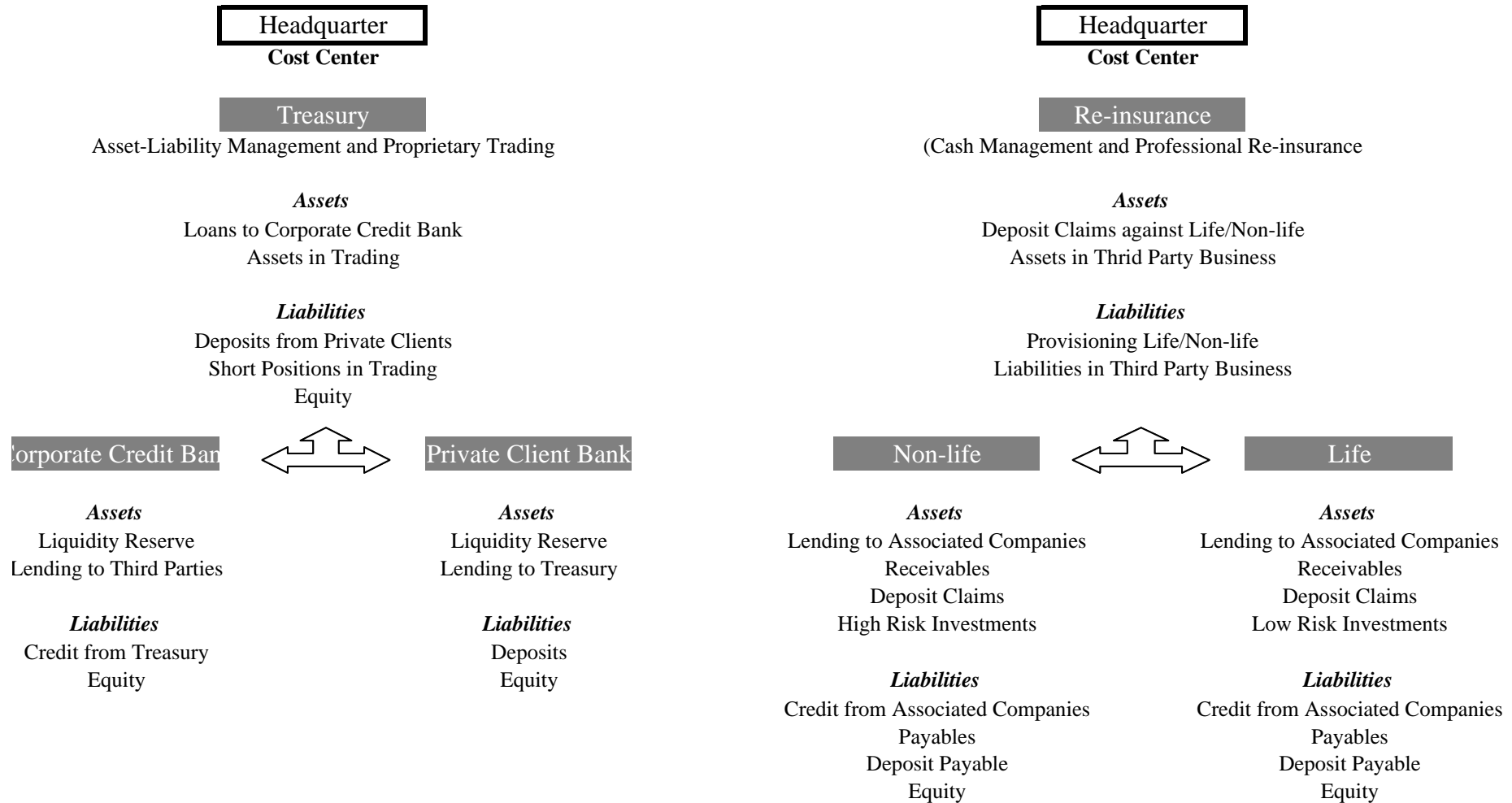
here: non-life insurance



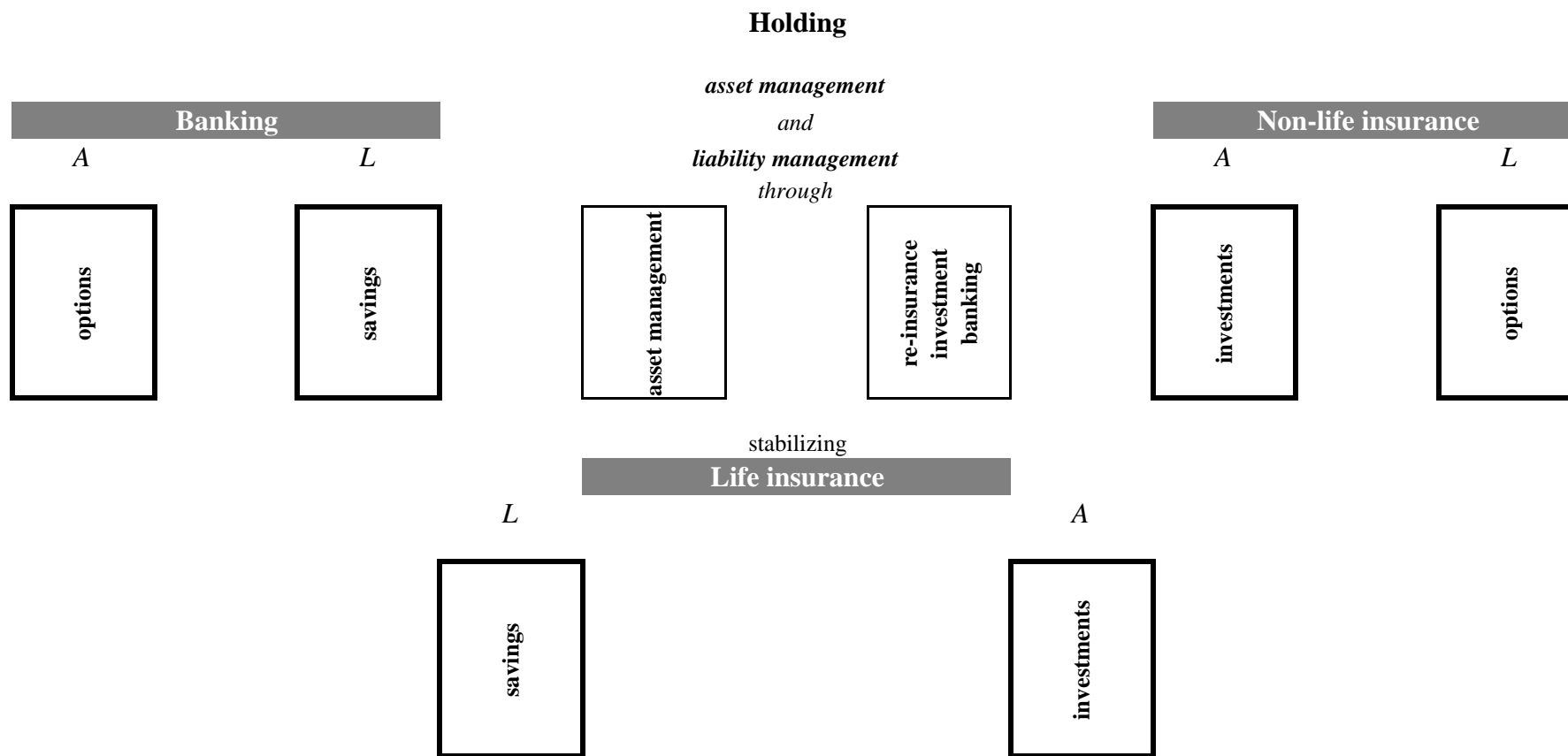
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## Typical organization of a business unit in banking or insurance



## Structure of a Group targeting an optimum of asset and liability management



**Competitive advantages:**

**Synergies:**

**Tax advantages:**

**Investment advantages:**

**Finance advantages:**

*client focussed services and range through multichannel system (cross selling)*

*risk advantages through diversification*

*international companies 10 - 30%*

*direct handel                      portfolio range*

*gezielte Kapitalaufnahme in niedrig zins ländern*

*R&D innovative products*

*regional focussed companies 40 - 60%*

*Marktmacht*

*höhere Bonität durch Stabilität*

*innovative products and cost leadership*

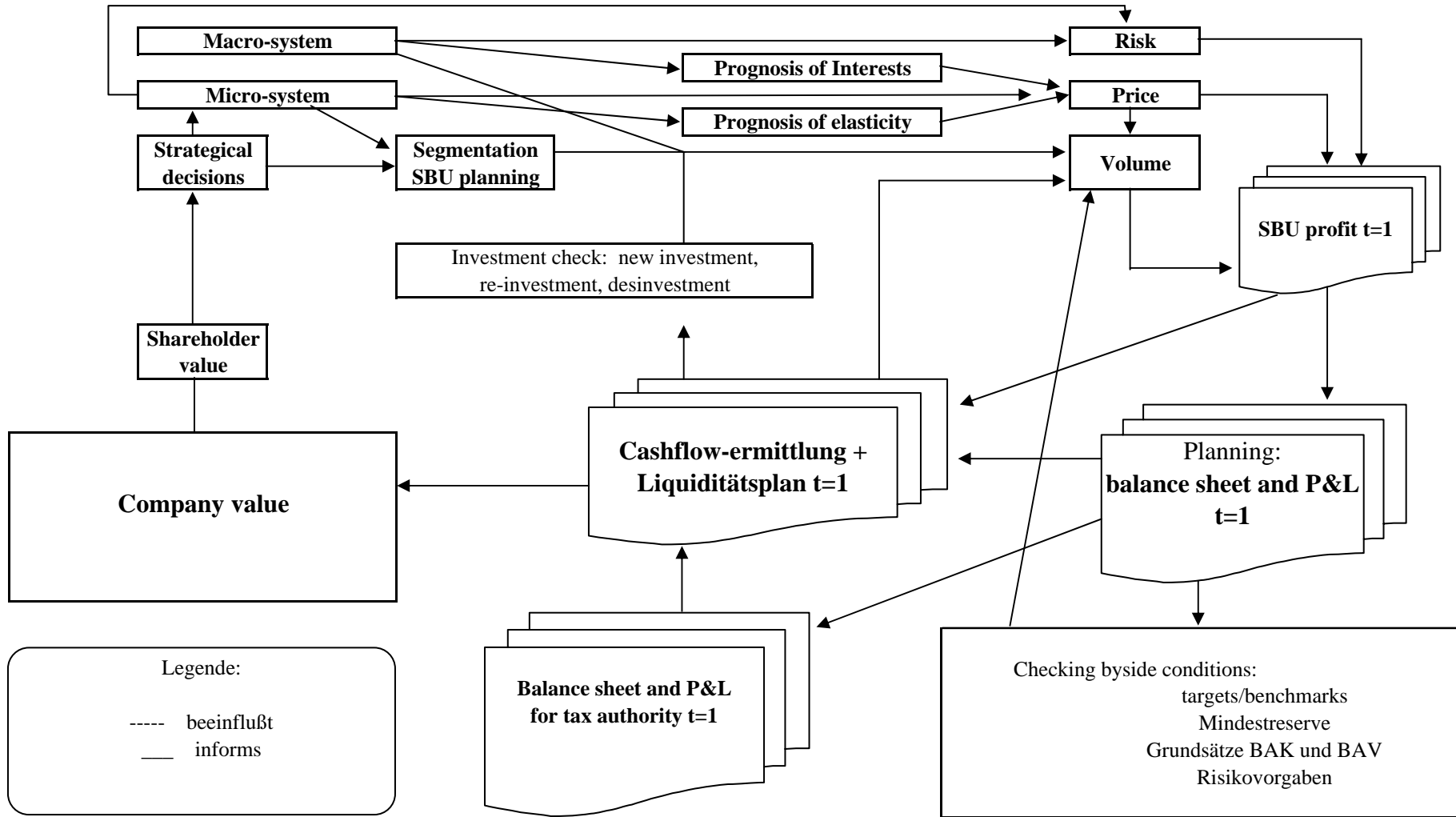
*cost advantages technology and technical use*

*hohe innenfinanzierungskraft*

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# Concept in total



## Example for an elasticity balance sheet

### Assets

Block	Position	Volume (in m)	Interest elasticity	Sensitivity of income*
0	1	2	3	4=2*3/100
fixed	Hyp.Darlehen	123	0	0
	Kom. Darlehen	51	0	0
	Pers. Darlehen	132	0	0
	Fo.a.Kl<1J.	31	0	0
	Fo.a.Kl>1J.	157	0	0
	Sonst. Aktiva	118	0	0
	Sum of fixed	612	0,0000	0
variable	Kontokorrent	106	0,80	0,848
	Termingeld (bis 90 Tage)	9	0,85	0,077
	Darlehen	140	0,60	0,840
	Sum of variabl	255	0,692	1,765
	<b>Total assets</b>	<b>867</b>	<b>0,2035</b>	<b>1,7645</b>

### Liabilities

Block	Position	Volume (in m)	Interest elasticity	Sensitivity of income*
5	6	7	8	9=7*8/100
fixed	Spk. Briefe	94	0	0
	sonstige	77	0	0
	Verb.g.Kl	139	0	0
	sonst.Passiva	142	0	0
	Sum of fixed	452	0,0000	0
	variable	Sichteinlagen	87	0,00
Termineinlagen (bis 90 Tage)		47	0,85	0,400
Spareinlagen		281	0,35	0,984
Sum of variabl		415	0,333	1,383
<b>Total liabilities</b>		<b>867</b>	<b>0,1595</b>	<b>1,383</b>

<i>Zinsergebnisveränderung Ge</i>	= (	<i>0,2035</i>	<i>abzgl.</i>	<i>0,1595</i>	) *	<i>867</i>	<i>m /</i>	<i>100</i>	=	<i>0,382</i>
<i>Festzins (-überhang) -Risiko</i>	= (	<i>612</i>	<i>abzgl.</i>	<i>452</i>	) *	<i>-0,333</i>	<i>/</i>	<i>100</i>	=	<i>-0,533</i>
<i>"Variable" Zinsänderungschance</i>	=	<i>255</i>	*	<i>0,692</i>	<i>abzgl.</i>	<i>255</i>	<i>* 1/100 *</i>	<i>0,333</i>	=	<i>0,915</i>

Source: Schierenbeck, Henner; Ertragsorientiertes Bankmanagement, 3. Auflage, S. 543

## Cashflow analysis of insurance companies and financial conglomerates

*Arizing number of financial service companies report cashflow statements. Some, however appear arbitrary in the way they are presented. If you notice irregularities, check the cashflow data through analysing its balance sheet and P&L data before working with their accounts.*

Profit on ordinary activities before tax and interests  
Depreciation

Realized gains and losses

Foreign exchange gains and losses

Increase in insurance funds

Decrease in deferred acquisition costs

Increase/decrease in other assets and liabilities

= **operating cashflow**

Correction for necessary maintenance investments

= **operating cashflow adjusted**

Income taxes

Interest tax shield

Changings in tax reserves

= **operating cashflow after tax**

Additional investments into working capital

Additional investments into fixed assets

= **ordinary free cashflow**

Adjustments by extraordinary changes

value adjustments to receivables of the banking operations

Advances or repayments lending

trading portfolio purchases or sales (securities and property)

funds entrusted to and debt securities of the banking operations

banks, not available on demand

interest tax shield becomes more important now

exchange rate differences in the past account to gross income in basic year  
(you should keep the exchange rates constant for prognosis, if appropriate)

= *Controlling by financial result (financial transactions)*

## How to value merging groups by DCF - a suggestion based on segmentation

segment	gross income in US\$ bn (previous year)	gross premium growth (on average)	operating cash margin (on average)	cash tax rate	additional investments fixed assets	additional investments work. capital	free cashflow margin (on average)	WACC	Residual value (gross)	Investor's value	Investor's v./ gross income
<b>Non-life</b>	<b>50</b>	<b>5,0%</b>	<b>30,0%</b>	<b>4,0%</b>	<b>0,1</b>	<b>1,7</b>	<b>20,0%</b>	<b>4,8%</b>	<b>220 bn</b>	<b>70 bn</b>	<b>1,4</b>
<b>Life</b>	<b>50</b>	<b>7,0%</b>	<b>50,0%</b>	<b>5,0%</b>	<b>0,1</b>	<b>5,0</b>	<b>14,0%</b>	<b>2,9%</b>	<b>260 bn</b>	<b>90 bn</b>	<b>1,8</b>
<b>Banking</b>	<b>20</b>	<b>9,0%</b>	<b>20,0%</b>	<b>15,0%</b>	<b>0,1</b>	<b>0</b>	<b>16,0%</b>	<b>8,8%</b>	<b>40 bn</b>	<b>30 bn</b>	<b>1,5</b>
<b>pro forma consolidated (weighted)</b>		<b>6,5%</b>	<b>36,7%</b>	<b>5,6%</b>	<b>0,1</b>	<b>2,8</b>	<b>17,0%</b>	<b>4,7%</b>	<b>460 bn</b>	<b>210 bn</b>	<b>1,8</b>
<i>Sum of the parts</i>									<u>520 bn</u>	<u>190 bn</u>	

**INPUT all red positions:**

Trading year (last reported)		1997
Gross premiums (last reported)	in bn	USD 120

**Development of key variables**

Period of forecast		1	2	3	4	5	6	7	8	9
Growth rate of gross premiums		6,5%	6,5%	6,5%	6,5%	7%	7%	7%	7%	7%
Operating cashflow margin		36,7%	36,7%	36,7%	36,7%	37%	37%	37%	37%	37%
Cash tax rate		5,6%	5,6%	5,6%	5,6%	6%	6%	6%	6%	6%
Add. investments rate into fixed assets	(factors)	0,1	0,1	0,1	0,1	0,1	0,1	0,1	0,1	0,1
Add. investments rate into working capital	(factors)	2,8	2,8	2,8	2,8	2,8	2,8	2,8	2,8	2,8
WACC Discounting factor		4,70%	4,70%	4,70%	4,70%	4,70%	4,70%	4,70%	4,70%	4,70%
Market value of liquid "untied" capital	in bn USD	0	0	0	0	0	0	0	0	0
Market value of liabilities (incl.outstand.secur.)	in bn USD	494	494	494	494	494	494	494	494	494
Third party shares (minorities)	in bn USD	0	0	0	0	0	0	0	0	0
Number of shares	in mn	1000	1000	1000	1000	1000	1000	1000	1000	1000

**Development of free cashflows**

Trading year		1998	1999	2000	2001	2002	2003	2004	2005	2006
Gross premiums		127,800	136,107	144,954	154,376	164,410	175,097	186,478	198,599	211,508
Net operating payments		80,897	86,156	91,756	97,720	104,072	110,836	118,041	125,713	133,885
Operating cashflow adjusted before tax		46,903	49,951	53,198	56,656	60,339	64,261	68,438	72,886	77,624
Cash taxes		2,627	2,797	2,979	3,173	3,379	3,599	3,833	4,082	4,347
Operating cashflow after tax		44,276	47,154	50,219	53,483	56,960	60,662	64,605	68,804	73,277
Additional investments into fixed assets		0,780	0,831	0,885	0,942	1,003	1,069	1,138	1,212	1,291
Additional investments into working capital		21,840	23,260	24,771	26,382	28,096	29,923	31,868	33,939	36,145
Free cashflow		21,656	23,064	24,563	26,159	27,860	29,671	31,599	33,653	35,841
<b>Discounted figures</b>										
Discounting factor		0,96	0,91	0,87	0,83	0,79	0,76	0,73	0,69	0,66
Present value of free cashflow		20,684	21,040	21,401	21,769	22,143	22,524	22,911	23,305	23,706
Cumulated present value of free cashflow	199,484	20,684	41,723	63,125	84,894	107,037	129,561	152,473	175,778	199,484
Residual value	762,568	460,767	490,717	522,614	556,583	592,761	631,291	672,325	716,026	762,568
Present residual value	504,380	440,083	447,649	455,345	463,173	471,136	479,236	487,475	495,856	504,380
Market value of liquid "untied" capital	0,000	0,000	0,000	0,000	0,000	0,000	0,000	0,000	0,000	0,000
Company value	703,864	460,767	489,373	518,470	548,067	578,173	608,797	639,948	671,633	703,864
Market value of liabilities (incl.outstand.secur.)	494,000	494,000	494,000	494,000	494,000	494,000	494,000	494,000	494,000	494,000
Third party shares (minorities)	0,000	0,000	0,000	0,000	0,000	0,000	0,000	0,000	0,000	0,000
Investor`s value	209,864	-33,233	-4,627	24,470	54,067	84,173	114,797	145,948	177,633	209,864
Number of shares in mn		1000,000	1000,000	1000,000	1000,000	1000,000	1000,000	1000,000	1000,000	1000,000
<b>Investor`s value per share in</b>	<b>USD</b>	<b>210</b>	<b>-33</b>	<b>-5</b>	<b>24</b>	<b>54</b>	<b>84</b>	<b>115</b>	<b>146</b>	<b>178</b>
<b>Sustainable price performance p.a.</b>	<b>on average</b>	<b>6%</b>								

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## Sector assumptions - for the market of **financial service industry** in maturation phase

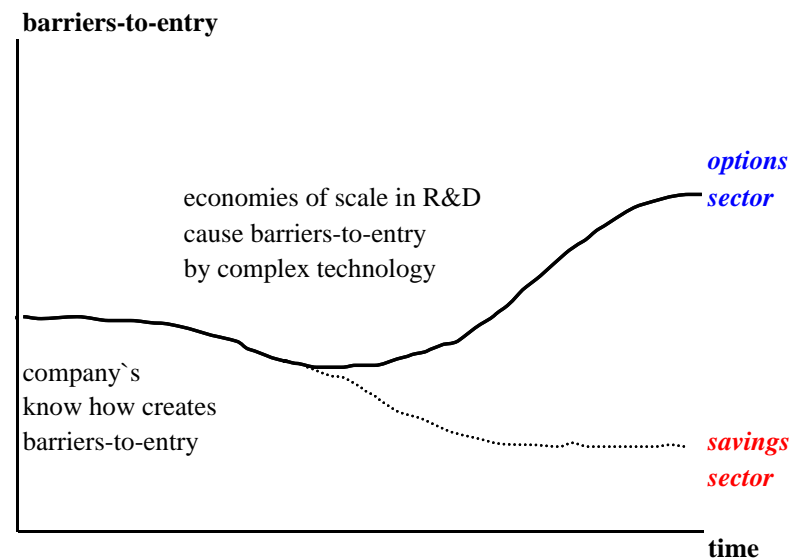
*Blue chips, supported by further mergers and purchases, will generate sufficient internal growth in the future.*

### Characteristics of savings branche

Substitution of products and configuration, no chance for innovation  
High demand growth, high operating cash margins shrink, decreasing profits  
Melting of life insurance, bank-savings and asset management  
Milestones: Cost advantages and access to distribution channels  
= **barriers to entry will stay low**

### Characteristics of options branche

Advantages of size in regard to R&D and loss development  
New products following technical and environmental development  
Melting of non-life insurance, re-insurance and financing (investment banking)  
Milestones: Economies of scale and capital requirements  
= **barriers to entry will increase again for non-standard products**  
= **barriers to entry will further decrease for standard products**



*Das Streiten um Distribution channels war ein frühes Indiz für die Maturation phase. Die verstopften Kanäle haben sich als wesentliche Eintrittsbarrieren auf dem Wege zu einer Konsolidierung herauskristallisiert.*

*Dies insbesondere im savingsbereich, in dem der Aufbau von Eintrittsbarrieren darüber hinaus schwer fallen dürfte.*

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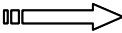


## **Trends identified in the European insurance and banking sectors**

*Regulators join forces when overseeing financial conglomerates. International banking, insurance and securities supervisors are following their industries' footsteps teaming up forces. Although it remains unclear exactly how many firms fall into that category, the number appears to have become significant, and grows by the day.*

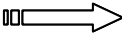


*The legal (supervisory) and tax relevant conditions will have converged over the coming five years. At the moment there is a positive bias for the banking sector: lack of legal minimum rate, free choice of investment and refinancing. By contrast insurers benefit from tax advantages on their interest income and special provisioning rules.*

Cost differences, resulting from differing distribution channels, will only disappear, when the electronic shopping will see its breakthrough or when there will be a marked shift of market shares towards the brokers. The high share of fixed costs allows banks to enjoy large economies of scale when growth is strong.

### **Three lines of development in the banking sector**

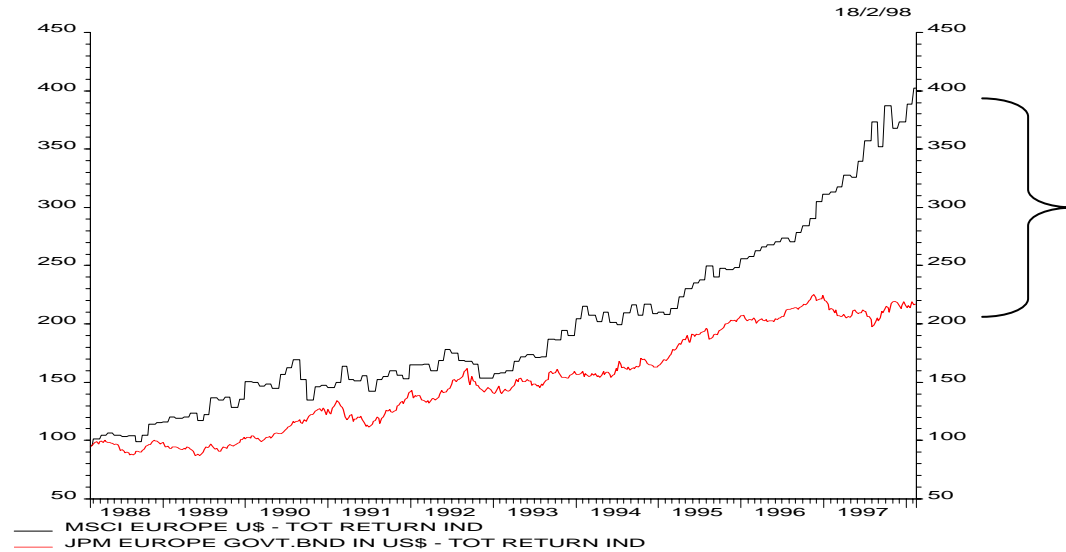
-  The concentration process at home proceeds very much within the different groups of institutes.
-  The net of affiliates is on retreat and electronic banking is on the rise.
-  Preparations are being made to deal with the EURO currency and its effects,

### **Three lines of development in the insurance sector**

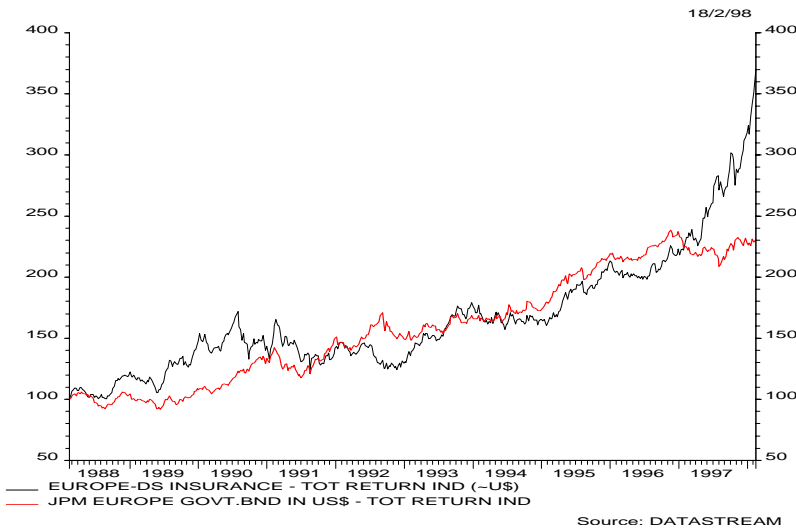
-  Almost all European markets suffer from a significant slow down in growth of the non-life business.
-  Concentration across national border lines brings economies of scale and overcomes congested distributed channels.
-  De-mutualisation improves the probability of the sector consolidating.

# There is a risk involved

Who will foot the bill?

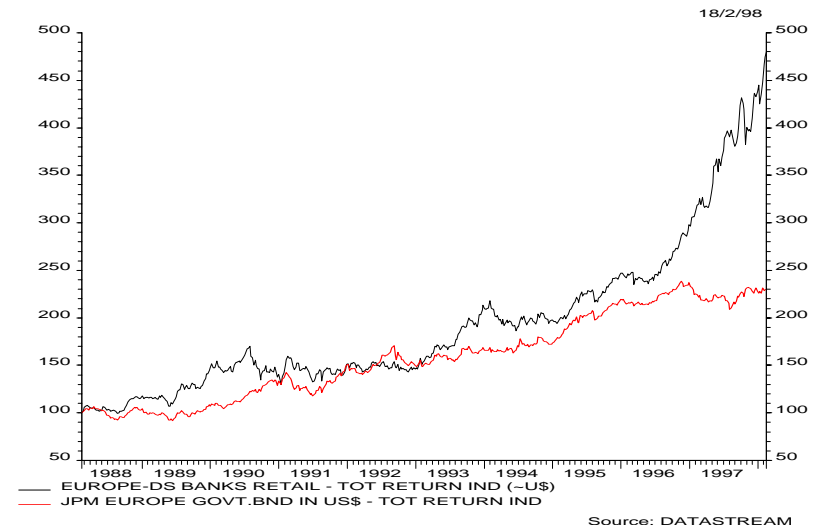


"risk" premium increasing



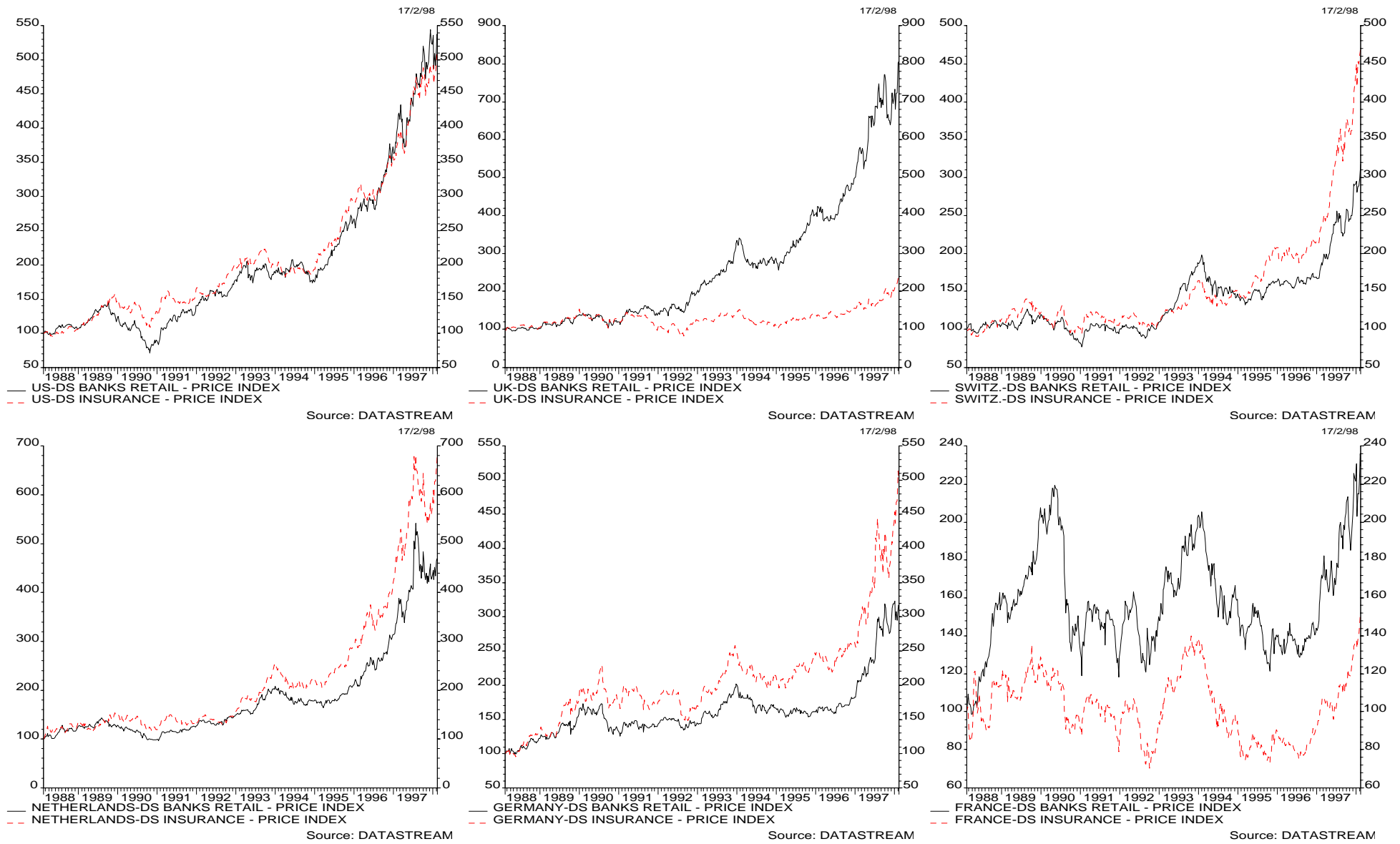
comparison of  
"risk" premium

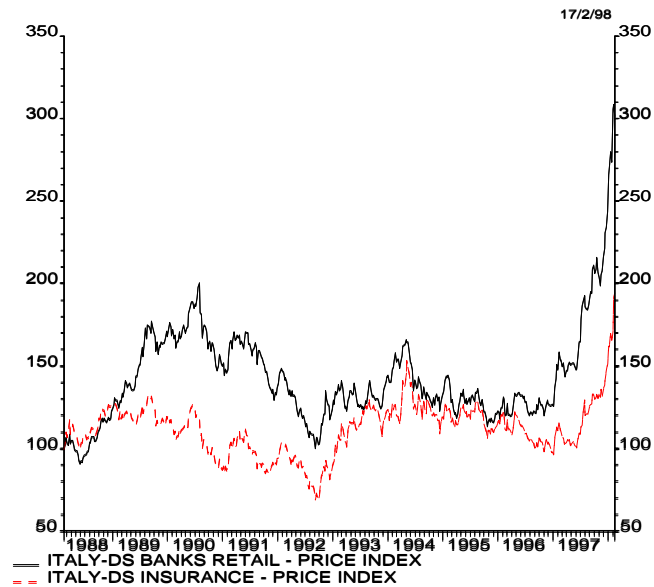
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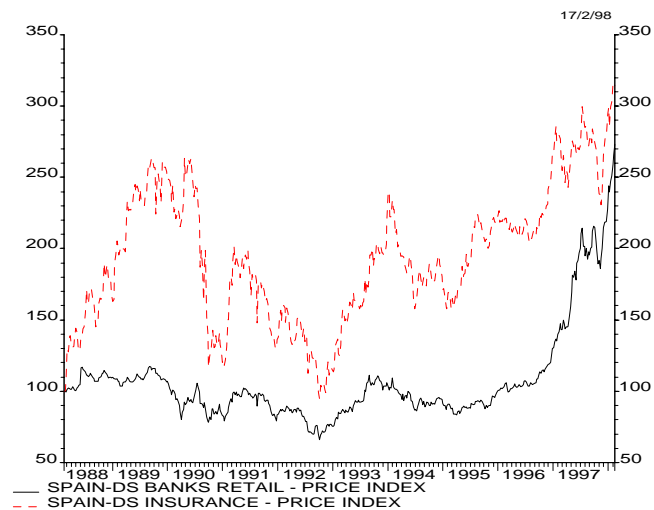
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Source: DATASTREAM



Source: DATASTREAM

Während einige Länder - USA, .. Einen erstaunlichen Gleichlauf der Performance im Banken und Versicherungssektor zeigen, weisen andere Länder - Spanien, ... Einen erstaunlichen spread auf, den größten Unterschied UK.

The UK sector look different. UK life insurers performed better than almost every other UK equity last year, rising 49 per cent in real terms. This was 25 percent better than the rest of the market and the third strong year in succession.

Distribution has been and will remain an important driver in the concentration process. Since Bancassurance peaked in the year 1994, there can be noticed a clear move to independent advisors. This after a heavy change in marketing rules. UK banks, with huge chains of High Street branches and sophisticated customer databases have the distribution set-ups. It is lack of product expertise and brand image which has stopped them gaining more than 10 per cent of the UK life market.

The UK market is sophisticated, and some of this product expertise could be exported to other parts of the world. On the other hand the UK sector is extremely fragmented in a way which looks unsustainable in the face of a move towards multinational multiline financial service giants.

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