Bank and Insurance
Capital Management

Frans de Weert

WILEY
A John Wiley and Sons, Ltd., Publication
## Contents

Preface xi  

Acknowledgements xv  

1 Capital Management as a Means to Create Value 1  
1.1 The primary objectives of capital management 1  
1.2 Optimization of capital structure 2  
1.3 Optimization of performance 4  

PART I: ACCOUNTING PERSPECTIVE 7  

2 Bank and Insurance Business Model 9  
2.1 Bank business model 9  
2.2 Insurance business model 12  

3 Balance Sheets of Banks and Insurance Companies 15  
3.1 Bank balance sheet 15  
3.2 Insurance balance sheet 18  
3.3 Goodwill 20  

4 Differences between Banking and Insurance 23  

5 Economic Capital 25  

6 Balance Sheet Management 31  
6.1 Capital versus balance sheet management 31  
6.2 Function versus departmental responsibilities 32
6.3 Capital hedging 36
6.4 Expected versus unexpected losses 37
6.5 Capital versus liquidity 39
6.6 Funds transfer price 39
6.7 Corporate line 40

7 Accounting versus Regulation 43

PART II: REGULATORY PERSPECTIVE 45

8 Types of Available Capital 47
  8.1 Bank capital components 47
  8.2 Insurance capital components 56
  8.3 Determination of available capital for insurance companies under Solvency II 58
  8.4 Capital treatment of dated hybrids 61
  8.5 Deduction of interests in other financial institutions 64

9 Capital Instruments 67
  9.1 Common shares 67
  9.2 Rights issue 68
  9.3 Preference shares 70
  9.4 Hybrid equity 71
  9.5 Convertible capital instruments 73

10 Regulatory Capital Requirements 75
  10.1 Bank capital requirement ratios 75
  10.2 Ratio hedging against currency movements 78
  10.3 The three-pillar approach to bank capital requirements 79
  10.4 Current capital requirements for insurance companies 93
  10.5 Upcoming capital requirements for insurance companies: Solvency II framework 95
  10.6 Liability side of the balance sheet under Solvency II 97
  10.7 Standardized approach Solvency II 102
11 Potential Changes in Capital Regulation 107
   11.1 Regulational shift to core capital 107
   11.2 Regulatory classification preference shares 110
   11.3 Hybrid regulation 111
   11.4 Subordinated debt for systemically relevant banks 115
   11.5 Positive revaluation reserves 115
   11.6 Minority interests 116
   11.7 Deferred tax assets 117
   11.8 Participations in other financial institutions 118
   11.9 Leverage ratio limit 118
   11.10 Financial autonomy 119

12 Reserve Adequacy Test 123

13 Materializing Diversification Benefits through Capital Structures 125

14 Risk-Weighted Assets Optimization 131

15 Balance Sheet Analysis as Integral Part of Valuation 135

PART III: RISK AND CAPITAL MANAGEMENT PERSPECTIVE 139

16 Investment of Capital and Balance Sheet Segmentation 141
   16.1 Investment of capital for banks 141
   16.2 Investment of capital for insurance companies 143
   16.3 Investment of capital: duration differences for banks and insurance companies 145
   16.4 Segmentation of the balance sheet 146

17 Alignment between Risk and Capital Management 149
   17.1 Where risk and capital management meet 149
   17.2 Capital preservation as a key condition for performance optimization 154
   17.3 The soft side of capital management 157
   17.4 Emerging role of risk and capital management 161
17.5 Critical success factors of risk and capital management 163
17.6 Differences in risk management per line of business 166

18 Risk-Adjusted Return on Capital and Economic Profit 171

19 Strategy, Risk, and Capital Management Cycle 177

PART IV: CORPORATE FINANCE PERSPECTIVE 181

20 Corporate Finance Decision Making 183
20.1 Role of RWAs in bank takeovers 183
20.2 Enterprise value versus market capitalization 185
20.3 Weighted average cost of capital and the optimal level of debt financing 187
20.4 Financial institution equity valuation 191
20.5 Capital buy-backs 194

21 Strategic Diversification 199

22 Conclusions 207
22.1 Capital management perspectives 209

Appendix A: Accounting Classifications 213

Appendix B: Credit Ratings 215

Appendix C: Standardized Approach of Solvency II 217
C.1 Market Risk 217
C.2 Counterparty default risk 224
C.3 Life risk 224
C.4 Non-life risk 226
C.5 Health risk 228
C.6 BSCR 230
C.7 Operational risk 230

Bibliography 233

Index 235