

Value and Capital Management

*A Handbook for the Finance and Risk
Functions of Financial Institutions*

THOMAS C. WILSON

WILEY

Contents

List of Abbreviations	xli
Preface	xvi
Acknowledgments	xix
About the Author	xxii
PART ONE	
Introduction	1
CHAPTER 1	
Why is Value Management Important?	3
Better Information	3
Better Insights	6
Better Decisions	8
Why Shareholder Value?	12
CHAPTER 2	
How do CFOs and CROs Add Value?	15
The Evolution of the Corporate Center as "Shareholder Surrogate"	15
The Implications for the CFO	20
The Implications for the CRO	24
PART TWO	
Better Information – Measuring Value	29
CHAPTER 3	
RAPMs – The Industry Standard	31
What Makes Financial Services Unique?	31
What do RAPMs do and How?	34
The RAPM (R)evolution	37
Three RAPMs for Three Distinct Purposes . . .	41
. . . Linking Directly to Shareholder Value	46

Insurance Example	49
Banking Example	50
CHAPTER 4	
Two Challenges hi Using RAPMs	51
Do RAPMs Influence Strategy?	51
Do RAPMs Give the Right Signals?	55
CHAPTER 5	
Valuing Financial Services – Tin Theory	71
What Determines Share Value? Market Multiples, RoE and Growth . . .	71
. . . But What Determines Market Multiples?	73
Why a Market-Consistent Approach?	77
Value: Where it Comes from and How to Create More of it	80
CHAPTER 6	
Valuing Financial Services – The Evidence	85
Evidence from the Insurance Industry	85
Evidence from Banking	96
Is it Just me or are Others Thinking the Same Thing?	98
CHAPTER 7	
Market-Consistent Valuation for insurers	101
Introduction to Fair Valuation for Insurers	101
Calculating Traditional Embedded Value	104
European Embedded Value	106
Market Consistent Embedded Value (MCEV)	109
How is MCEV Calculated in Practice?	115
From MCEV to MVBS	120
Final Comments: Whither MCEV?	122
RABTTWS	
Better Insights – Managing Value	125
CHAPTER 8	
Property and Casualty bistrance	127
History and Economic Rationale	127
From Principles to Rules of the Game	133
From Rules to the Valuation of PC Businesses	135
PC KPIs: Understanding and Managingalue	140
CHAPTER 9	
Life and Health insurance	151
History and Economic Rationale	151
From Principles to "Rules of the Game"	163

LH Valuation	167
Understanding Value Creation: Capital Intensity and Financial Risk Taking	171
CHAPTER 10	
Banking	189
History	189
Products	195
Economic Rationale	197
From Principles to "Rules of the Game"	199
From "Rules" to Value	201
CHAPTER 11	
Achieving Profitable Growth	211
Rules of the Game and KPIs	211
Management Actions – Three Horizons of Growth	217
Horizon 1 – Increasing Sales Productivity	218
Horizon 1 – Going Multi-channel	221
Horizon 1 – Getting More out of Existing Customers; cross sell, big data and customer loyalty	224
Horizon 1 – Managing the Customer Portfolio Skely	228
Horizon 2 – Anticipating Mega-trends	230
Horizon 2 – Exploiting Adjacencies	232
Horizon 2 – Transformational and Bolt-on Acquisitions	234
Horizon 3 – Creative Disruptions	238
CHAPTER 12	
Achieving Operating Efficiency	241
The Importance of Operating Efficiency	242
Rules of the Game	248
Pay Less: Optimize Procurement	249
Pay Less: From Business Process Redesign to Outsourcing	250
Use Less, But More Effectively: Digitize and Automate	253
Use Less, But More Effectively: Re-engineer the Product Portfolio	254
Use Less, But More Effectively: Managing Acquisition Expenses	257
MRff IQUR	
Better Decisions – Capital, Balance Sheet and Risk Management	261
CHAPT3	
Corporate Strategy and Capital Allocation	263
Corporate Strategy, Capital Allocation and Performance Management	263
Capital Allocation: The Capital Budget, from Sources to Uses of Capital	265
Capital Allocation: Optimizing the Corporate Portfolio	273
Capital Allocation: Aligning Financial Resources within Constraints	278

CHAPTER 14	
Strategic Planning and Performance Management	285
What is Strategic Planning?	285
Why does Strategic Planning Fail and What can be done About it?	295
Corporate Strategy	302
CHAPTER 15	
Balance Sheet Management	311
Balance Sheet Management Activities	311
The Asset/Liability Committee (ALCO) Mandate and Agenda	314
The Asset/Liability Management (ALM) Unit	323
The Insurer ALM-Investment Value Chain	330
The Treasury Function	339
CHAPTER 1B	
The Economics of Asset/Liability Management	345
The Role of ALM Earnings	345
The Risks: Some Spectacular ALM Failures	349
The Returns: Are Shareholders Willing to Pay a Premium or a Discount?	361
CHAPTER 17	
The Practical Aspects of Asset/Liability Management	371
ALM Performance and Risk Measures	372
Calculating Funds Transfer Prices (FTPs)	385
Measuring Alpha	406
CHAPTER 18	
Cash and Liquidity Management	413
Managing Funding Liquidity Risk	413
What Happens if it Goes Wrong?	416
Measuring Funding Liquidity Risk	420
CHAPTER 13	
Managing the Capital and Funding Structure	431
Capital Funding Management	431
Determining the Optimal Capital Structure	436
The Empirical Reality: What Determines Capital Structure?	446
CHAPTER 20	
Risk Management	451
Enterprise Risk Management	451
Taking the Right Decisions	460
The Role of Culture	463
CHAPTER 21	
Risk Governance and Organization	477
Risk Governance Principles	477

Role of the Board and Management	478
Three-Line-of-Defense Model	480
The Risk Function	484
CHAPTER 22	
Risk Identification and Evaluation	481
From Risk Identification to Evaluation	491
Data-Driven Approaches	497
Evaluation-Based Approaches	499
Building a Resilient Organization	507
CHAPTER 23	
Risk Underwriting – Strategy and Governance	513
Underwriting Context	513
Underwriting Strategy	518
Underwriting Governance	522
CHAPTER 24	
Risk Underwriting – Technical Tools	527
Retail Segment: "Scoring" Models	527
Commercial Lines: Leveraging Expert Judgment	535
Underwriting Structured Solutions	541
Underwriting Controls, Validation and Learning	542
CHAPTER 25	
Risk Underwriting – From Technical Pricing to Value Maximization	548
Technical Production Cost: RAPM Pricing	549
From Technical Pricing to Optimal Price	558
CHAPTER 26	
Managing Operational and Reputational Risks	571
Defining Operational Risk	571
Managing Operational Risk	581
CHAPTER 27	
Risk and Limit Control	588
Risk Reporting	589
An Effective Risk Limit Framework	601
Final Thoughts on Risk and Limit Reporting	606
Appendices	
Appendix A: Market Multiple Approaches	609
Appendix B: Derivation of Steady-State Valuation Multiples	613

Appendx C: Valuing Banks and kisurens: The Link Between Value and New Business and Investment RAPM	621
Appendx O: Beyond Debt and Equity	BBS
GLOSSARY	641
REFHBVCES	653
Index	675