1 Capital Management as a Means to Create Value

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The core message of this book is that capital management is a means to create value. In order to manage capital so that value is actually being created, one needs to have an understanding of many different topics. However, when these topics are discussed in isolation, it might not always be clear how each relates to capital management, let alone understand the role each plays in the value creating function of capital management. This chapter summarizes the main objectives of capital management and how the activities to realize these objectives fit into the broader management context of financial institutions. The chapter should also help the reader to place the topics that are discussed throughout this book in a broader capital management context. Because this chapter is conclusive in nature it might be that the reader is not familiar with all the terminology and concepts that are used. If this is the case, do not be deterred as the concepts and terminology are explained in subsequent chapters.

1.1 THE PRIMARY OBJECTIVES OF CAPITAL MANAGEMENT

Capital management has two primary objectives:

1. *Optimize capital structure.* This is an objective that capital management has to fulfil almost entirely by itself and evolves around the financing of business operations.[1] The activities that capital management undertakes to achieve this objective should ultimately result in an *optimal cost of capital*.
2. *Optimize performance.* The activities that need to be employed to fulfil this objective lie partly with the individual businesses and risk management. Even though, in order to optimize performance, capital

[1] Selling deposits or underwriting insurance policies are part of business operations and are not capital management considerations when optimizing the capital structure.

management is dependent on other areas within a financial institution, it should act as the owner of this optimization process. In this role, it should oversee and manage this process. Apart from developing a corporate strategy,[2] the activities to pursue this objective are similar to the activities of the strategy, risk, and capital management cycle as described in Chapter 19. If successful, these activities should lead to an *optimal return on capital.*

Figure 1.1 displays the main activities necessary to fulfil the two primary objectives of capital management. Both objectives need to be achieved in order to create maximum value. The next two sections explain each of the two primary objectives of capital management in more detail.

1.2 OPTIMIZATION OF CAPITAL STRUCTURE

Figure 1.1 shows the four main responsibilities of capital management in order to optimize the capital structure. When performed well, this should result in an optimal cost of capital. The four main responsibilities of this optimization process are discussed throughout the book, for which capital management is almost solely responsible. To summarize, these responsibilities are:

1. *Fulfil regulatory requirements.* This is a *conditio sine qua non* and means, among other things, that a financial institution's available capital should exceed required capital. Hence, capital management should always check whether its optimal capital structure fulfils regulatory requirements. If it does not, capital management needs to continue its optimization loops until regulatory requirements are fulfilled. Because there is some leeway in how to fulfil these regulatory requirements, it does not need to be imposed as a single condition in the optimization process. However, capital management does need to "tweak" its optimization until the requirements are fulfilled.

   Some people would argue that the regulator is a stakeholder that needs to be satisfied. This book treats *fulfilling of regulatory requirements* as a separate responsibility, because of their transparency and mandatory nature. Part II explains what capital management needs to do in order to *fulfil regulatory requirements*.

[2] The CEO is responsible for developing a corporate strategy.

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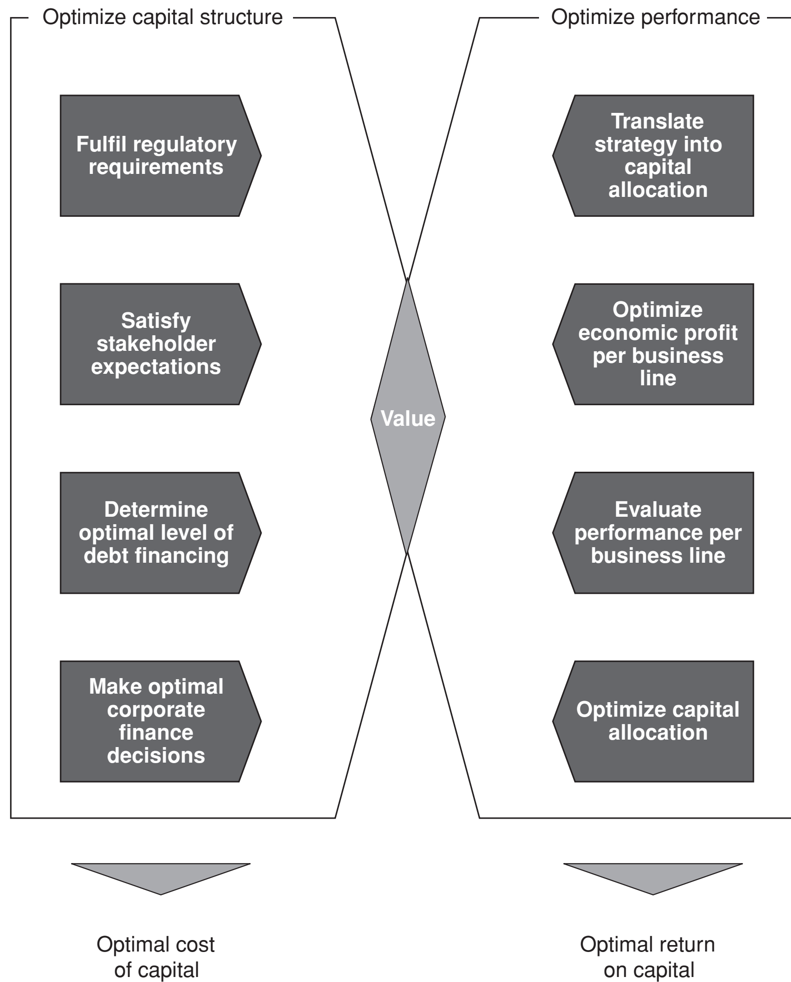

Figure 1.1 The two objectives of capital management.

2. *Satisfy stakeholder expectations.* In contrast to regulatory requirements, which are to a great extent transparent, it is hard to understand the exact expectations of different stakeholders. In general, a financial institution only gets signals if it is not satisfying certain stakeholder expectations. If this happens, it is already too late, because the financial institution needs to bear the negative consequences of the irrational behaviour of these unsatisfied stakeholders. It is crucial that a financial institution never finds itself in this situation.

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Capital management is therefore responsible for conducting careful stakeholder analyses, and ensuring that the expectations of relevant stakeholders are met at all times. Or at least, if capital management chooses not to satisfy a certain stakeholder, it should be absolutely sure that the financial institution is able to withstand the potentially negative consequences. Satisfying stakeholder expectations is dubbed *the soft side of capital management* in section 17.3.

Capital management should go through optimization loops until the expectations of all relevant stakeholders are satisfied.

3. *Determine optimal level of debt financing.* This lies at the core of the cost of the capital optimization process. The main constraints for this optimization are stakeholder expectations and regulatory requirements. How to *determine the optimal level of debt financing* is discussed in section 20.3.
4. *Make optimal corporate finance decisions.* These are the more ad hoc type of decisions, such as acquisitions, but it is crucial to carefully think these decisions over as they can heavily impact the capital structure and therefore the cost of capital. How this is done in practice is explained in Chapter 20.

1.3 OPTIMIZATION OF PERFORMANCE

With respect to optimization of performance, capital management relies heavily on the individual businesses and risk management. Although optimization of (commercial) performance is primarily a responsibility of the individual businesses, capital management should drive this process in order to achieve an optimal return on capital on a consolidated basis. Nevertheless, the actual performance improvements need to be established by the businesses with the ‘aid’ of risk management. Capital management can influence this process by reallocating capital from businesses that perform relatively poorly to businesses that perform well. The main activities in order to achieve an optimal return on capital are discussed in Part III and can be summarized as:

1. *Translate strategy into capital allocation.* Once a corporate strategy has been formulated, available capital needs to be allocated in line with this strategy. However, this requires significant fine-tuning with the different businesses in terms of how and when this capital is actually allocated. Indeed, the allocated capital has to be in line with the size of the business. Even if the strategy is to expand a certain

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business, this does not happen overnight. Hence, capital needs to be allocated over time, in line with the strategies of the individual businesses.

2. *Optimize economic profit per business line.* Once capital is allocated, the individual businesses and business risk management are responsible for getting the most out of this capital. In other words, the individual businesses need to continually improve their economic profit. Risk management challenges the individual businesses on the business they undertake and sets guidelines within which these businesses need to operate. Optimization of economic profit per business line is not a responsibility of capital management, but rather of the business and business risk management. This is discussed in Chapters 18 and 19.
3. *Evaluate performance per business line.* Performance evaluation is again a responsibility of capital management. As part of this activity, capital management evaluates how well businesses are performing and challenges them on how these individual businesses can improve their performance. Part of this performance evaluation is to compare RAROC (risk-adjusted return on capital) and economic profit growth potential. How this works exactly is discussed in Chapters 18 and 19.
4. *Optimize capital allocation.* Based on the performance evaluation, capital management should optimize its available capital allocation. This could mean that it has to reallocate capital from poorly performing businesses, or businesses with little growth expectations, to well-performing and high-growth businesses. This is also discussed in Chapters 18 and 19.