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INTEGRATING RISK MANAGEMENT AND CAPITAL MANAGEMENT

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This article is a shorter, less technical version of Chapter 3 of Prakash Shimpi (ed.), *Integrating Corporate Risk Management* (Texere LLC, London and New York, 1999, 2001). Copyright is held by Swiss Re.

Abstract

Capital management and risk management are two sides of the same coin. But by treating them separately, the conventional theory and practice of corporate finance fails to account for important connections between them. Moreover, an exclusive focus on debt and equity ignores the full range of capital resources available to a corporation, thus distorting management's view of the firm's cost of capital (and its return on equity).

An understanding of the role of corporate capital–including off-balance sheet as well as paid-up capital—and its relationship to the riskiness of a firm's activities provides the foundation on which the author builds a corporate finance framework that ties together both the insurance and capital markets. This framework, called the “Insurative Model,” captures the economics of both conventional insurance and corporate finance instruments and embraces a wide variety of solutions and instruments—be they debt, equity, insurance, derivative, contingent capital, or any other—and allows managers to evaluate their effectiveness in a consistent, unified way.

The Insurative Model demonstrates that a company's decisions on insurance and risk retention can be just as important as its decisions about its debt-equity mix. In fact, the determination of a firm's optimal debt-equity ratio should be *the last* in a series of capital and risk management decisions. Earlier decisions should address risk retention, risk transfer, and the optimal amounts and structure of off-balance-sheet capital used to support the company's retained risks.