Optimal Capital Allocation Principles

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ABSTRACT

Evaluating capital requirements as well as allocating total capital into various business units are becoming increasingly important part of the risk management process of a financial enterprise. In the allocation of capital, we consider the purpose of capital allocation within a company (individual, collective, or market-relative), the manner in which the portfolios within the conglomerate can possibly interact (pooled, partially pooled, or presence of firewalls), as well as the company’s attitude towards risk (risk aversion). In this paper, we examine some of the fundamental principles of fairly allocating the total capital when these considerations are taken into account. We are able to generalize allocation principles by a re-expression of the allocation issue as a distance optimization problem. No allocation formula is all-encompassing but these optimization criteria provide insights into the allocation process.

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