

Next Steps for ERM: Valuation and Risk Pricing

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Abstract

ERM has methodology for quantifying the risk to capital, but to determine optimal capital the impact of capital level on firm value is needed. This gets into the realm of valuation. Also capital allocation provides risk quantification for business units, but comparing return among units is fundamentally a risk-pricing exercise. When considering risk pricing, optimal returns on allocated capital are not necessarily constant across business units. The current ERM methodology, as well as actuarial literature on valuation and pricing, are reviewed, and possible directions for application of pricing and valuation methods to risk management problems are outlined.

Keywords:

ERM; risk pricing; firm value; capital allocation.