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Co-Managing Economic and Regulatory Capital With Corporate Finance Optimization

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Abstract

As the use of internal economic capital models becomes more pervasive in the banking and insurance industries, practitioners are challenged to manage their internal assessment of economic risk capital alongside regulatory constraints. To the extent that economic and regulatory capital differ, firms must deploy return on equity (ROE) maximizing strategies that take both risk measures into account. Most strategies presented in existing literature focus on the risk, or "demand," side of the equation—fine-tuning business mix/investment strategy to maximize economic profit while keeping regulatory capital requirements in check. In this paper, the focus is on the "supply" side—fine-tuning the source (and cost) of capital available to support risk. This paper demonstrates how this mechanism can be used to optimize a firm's corporate finance structure. In an optimal capital structure, investors are compensated commensurate to the riskiness of their capital, and redundant, or "idle," regulatory capital requirements are minimized if not altogether eliminated.

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