Topics of Capital Allocation

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1 Executive Summary

This report consists of two studies on capital allocation conducted within the Topics of Capital Allocation Project at IRFRC. The main thrust of the research was to reconcile capital allocation theory with two practical problems that arise in practice. The first problem is that current theory assumes perfect information about the set of underwriting opportunities when constructing an optimal portfolio: Unfortunately, in practice the underwriter must build the portfolio in real time and confront the uncertainty about what opportunities will arise in the future. The second problem concerns instability of capital allocations: When using gradient methods for allocation, small changes to the portfolio can generate large changes to allocated capital. While practitioners have used a variety of ad hoc methods to deal with these two problems, in this paper we consider the normative question of how the problems should be dealt with—at least under certain circumstances.

The first study tackles the first problem by studying the capital allocation rule in a dynamic portfolio optimization problem with irreversible investments. Specifically, we consider the situation that 1) decisions must be made about those opportunities when they arrive and 2) those decisions are typically irreversible, or reversible only with significant cost. We find that marginal cost pricing can still be connected to capital allocation in this setup, although the basis for allocation is different from that found in static problems. The investment decision for an opportunity presented today is made on the basis of an expected future marginal cost of risk associated with that opportunity. The capital allocated for today’s opportunity is a probability-weighted average of the product of the marginal value of capital in future states of the world and the amount of capital consumed by today’s opportunity in those future states. In addition, our numerical examples show that failure to explicitly model uncertainties regarding future opportunities can lead to misstatement of the marginal cost of risk, and, as a result, over-investment or under-investment in current opportunities.

In the second study, we address the problem of allocative instability in the context of a case where capital must be allocated but the portfolio of risk is fixed. In this situation, allocating capital based on how it is consumed when risk is expanded at the margin is no
longer economically relevant. We apply Moulin’s notion of egalitarian equivalent cost sharing of a public good to the problem of insurance capitalization and capital allocation where the liability portfolio is fixed. Using numerical examples, we show that this approach yields overall capitalization and cost allocations that are Pareto efficient, individually rational, and, unlike other mechanisms, stable in the sense of adhering to cost monotonicity.
2 Dynamic Capital Allocation with Irreversible Investments

This section is a working paper of Bauer, Kamiya, Ping, and Zanjani (2016).

2.1 Motivation

Practitioners have long wrestled with the problem of how to allocate a financial institution’s capital to the various risks within its portfolio for purposes of pricing and performance measurement. Over the past 15 years, a number of papers have explored the problem of allocating capital based on marginal risk contributions in different settings via different conceptual approaches (see Bauer and Zanjani (2013) for a review). However, these techniques are largely restricted to static portfolios, where the exposures are either set in advance or chosen simultaneously in an optimization problem.¹

Unfortunately, the real world application of these concepts is more complicated. Specifically, allocation for pricing purposes is typically done in an environment where the portfolio is not fixed in advance and is instead in the process of being constructed. Opportunities for underwriting or investments do not all arrive at the same time. If they did, or if positions in existing opportunities could be costlessly modified as new opportunities arrived, existing allocation techniques could be applied without modification. More typically, however, opportunities arrive sequentially in time, and, moreover, 1) decisions must be made about those opportunities when they arrive and 2) those decisions are typically irreversible, or reversible only with significant cost. This characterization applies to insurance companies, private equity firms, banks, and other institutions dealing in illiquid investments. How should risk be priced in such an environment? And can risk pricing be connected to capital allocation?

This paper tackles these questions by studying the usual portfolio optimization problem—where expected returns are optimized subject to a risk measure constraint—with three complications motivated by the discussion above. First, investment opportunities arrive sequentially. Second, the risk and return properties of future opportunities are uncertain.

¹While some papers do study “dynamic” approaches to allocation (Tsanakas (2004); Laeven and Goovaerts (2004)), the “dynamics” are introduced by evolving information about the components of a previously chosen portfolio rather than changes to the composition of the portfolio itself.
Third, investment decisions are irreversible.

We find that marginal cost pricing can indeed be connected to capital allocation in this setup, although the basis for allocation is different from that found in static problems. In static problems, the marginal value of capital is known with certainty, and capital is allocated to each risk based on how it consumes that capital at the margin. In this dynamic problem, the ultimate marginal value of a dollar of capital will not be known until all opportunities have been presented and decisions have been made; similarly, it is also not known what demands a given investment will make on the firm’s capital until the portfolio is set. What is known—assuming that the uncertainty in the risk and return structure of future opportunities is understood—is the future distribution of possibilities. To elaborate, we know the possible paths ahead and their probabilities, so we know what the value of a marginal unit of capital will be in various future states of the world, and we also know in each of those states how that marginal unit of capital is consumed by the risks in the portfolio.

Thus, the investment decision for an opportunity presented today is made on the basis of an expected future marginal cost of risk associated with that opportunity. Expected future marginal costs can alternatively be expressed in terms of an allocation of the firm’s capital cost to current investments and future opportunities. The basis of the allocation for today’s opportunity is a probability-weighted average of the product of the marginal value of capital in future states of the world and the amount of capital consumed by today’s opportunity in those future states of the world.

Part of the logic and intuition of the model is related to the literature on real options (e.g., Dixit and Pindyck (1994)). The fundamental problem in this literature entails the impact of uncertainty on investments that are either partially or completely irreversible. The classic intuition is that simple internal rate of return calculations, using a firm’s cost of capital as a hurdle rate, lead to overly aggressive investment because they fail to account for the option value of waiting for more information on the productivity of the investment. As a result, hurdle rates need to be adjusted upward, and greater uncertainty about productivity can be shown to lead to even higher hurdle rates (e.g., McDonald and Siegel (1986)). To the extent that the amount of investment is discretionary, current investment is delayed or
reduced as there is value created by waiting.

Counteracting diversification effects, however, are introduced by the portfolio context of the problem studied in this paper. Since the ultimate productivity of any investment is determined by the final full portfolio of investments, early opportunities may receive relatively heavy investment relative to the attractiveness of their risk and return properties when viewed in the context of the current portfolio. The firm may invest heavily in anticipation of later additions to the portfolio, which will make the early opportunity more attractive in the end. Opportunities that arrive late in an underwriting season, however, will tend to be judged in the context of the portfolio as it exists at that point in time, as the firm has much less flexibility in building a portfolio around the opportunity in question.

The rest of this paper is organized as follows. We start in Section 2.2 by sketching basic theory in a two period model to build intuition. A multiperiod generalization is provided in an Appendix A, which is then specialized to a Markovian setting in Section 2.3 to produce numerical examples showing how future uncertainties can affect optimal decisionmaking today. Concluding remarks are provided in Section 2.4.

2.2 General Dynamic Capital Allocation

We consider first the case of two investment opportunities in two periods, and then discuss the generalization of the analysis to multiple investment opportunities in the Appendix.

The financial institution receives two opportunities in sequence. Upon receipt of the first opportunity, it must decide on the quantity $q_0$ to invest in the opportunity. The second opportunity is known to be coming, but there is uncertainty about its risk and return properties. This uncertainty is denoted by the random variable $\alpha$, which takes values in the set $\{\alpha_1, \cdots, \alpha_m\}$ with probabilities $\{p(\alpha_1), \cdots, p(\alpha_m)\}$. The uncertainty is resolved upon receipt of the second opportunity, at which point the firm decides on the quantity $q_1$ to invest in the second opportunity.

Let the return on the first opportunity be a random variable $r_0$ and the return on the second have a distribution that depends on the realization of $\alpha$, as in $r_1(\alpha_i)$. Thus, different realizations of $\alpha$ will affect the prospective distribution of outcomes for the second
opportunity. Let the firm’s cost of risk bearing be $\tau$, with risk capital needed to support the exposures being captured by the measure $\rho(q_0, q_1^i; \alpha_i)$.\(^2\) If we consider the firm’s problem at decision time on the first opportunity, we can frame the optimization problem as choosing a quantity for the first investment and a set of plans—contingent on different realizations of $\alpha$—for the second investment:

$$\max_{q_0, \{q_1^i, \ldots, q_m^i\}} q_0 \mathbb{E}[r_0] + \sum_{i=1}^{m} p(\alpha_i) \left( q_1^i \mathbb{E}[r_1(\alpha_i)] - \tau \rho(q_0, q_1^i; \alpha_i) \right),$$

subject to a set of constraints restricting the total amount of risk capital to a maximum level $K$:

$$\rho(q_0, q_1^i; \alpha_i) \leq K \quad \forall i = 1, \ldots, m.$$  \(^{(2)}\)

The first order conditions can be expressed as:

$$\mathbb{E}[r_0] - \sum_{i=1}^{m} (p(\alpha_i)\tau + \lambda_i) \frac{\partial \rho(q_0, q_1^i; \alpha_i)}{\partial q_0} = 0,$$  \(^{(3)}\)

$$p(\alpha_i)\mathbb{E}[r_1(\alpha_i)] - (p(\alpha_i)\tau + \lambda_i) \frac{\partial \rho(q_0, q_1^i; \alpha_i)}{\partial q_1^i} = 0, \quad i = 1, \ldots, m,$$  \(^{(4)}\)

where $\lambda_i$ is the Lagrange multiplier associated with constraint $i$. Equation (3) balances the marginal benefit of exposure to the first risk (the expected return) with its marginal cost, while equation (4) does the same for the second risk in each of the possible states of the world.

Marginal cost is driven by the per unit cost of risk capital $\tau$, as well as the costs relating to the maximum risk constraint, which are captured by the Lagrange multipliers $\lambda_i$. Note in each state that $\lambda_i$ reflects an additional shadow cost or marginal value of state-contingent risk capital (i.e., at time zero, what an additional dollar of capital in state $i$—and only in state $i$—would be worth to the firm, net of the risk bearing cost $\tau$). When (3) holds for

\(^{2}\)It is also possible to write the objective function as an expected return minus frictional costs associated with capital, as in $\tau K$, so that the firm is burdened with a cost of capital rather than a cost of risk. Results of a largely similar flavor are obtained in this case.
an interior solution, we may write:

$$\lambda_i = p(\alpha_i) \frac{\mathbb{E}[r_1(\alpha_i)] - \tau \frac{\partial \rho(q_0, q_1^i; \alpha_i)}{\partial q_0^i}}{\frac{\partial \rho(q_0, q_1^i; \alpha_i)}{\partial q_1^i}} \quad \forall i = 1, \ldots, m. \tag{5}$$

It is possible for this shadow cost to be zero in states where the total risk constraint is not binding; in such states, the firm has additional capacity for risk and does not have use for it any more.

Thus, the marginal cost of exposure in each case is equal to the marginal amount of risk capital used (calculated as the partial derivative of the risk measure with respect to the quantity of the risk) times the sum of the frictional cost of risk $\tau$ and any additional shadow cost of risk capital used to support that risk. In the case of the first exposure, risk capital is affected in all possible future states of the world since the firm must commit to the exposure before the resolution of uncertainty, as seen in equation (5). The exact amount consumed as a result of the first underwriting decision, however, is uncertain and determined by the later underwriting decision.

Marginal cost can be reinterpreted as an allocation of risk capital times a cost if the risk measure is homogeneous. Working with the second terms in (5) and (3):

$$\sum_{i=1}^{m} (p(\alpha_i) \tau + \lambda_i) \left[ \frac{\partial \rho(q_0, q_1^i; \alpha_i)}{\partial q_0} q_0 + \frac{\partial \rho(q_0, q_1^i; \alpha_i)}{\partial q_1^i} q_1^i \right] = \tau \bar{\rho} + \sum_{i=1}^{m} \lambda_i K, \tag{6}$$

where $\bar{\rho} = \sum_{i} p(\alpha_i) \rho(q_0, q_1^i; \alpha_i)$ is the expected value of risk capital used. It is useful to consider two polar cases. First, if the total risk constraint never binds, then the sum of marginal costs times exposures contemplated in (6) reduces to $\tau \bar{\rho}$. In this case, total capacity $K$ is never fully utilized; the expected risk $\bar{\rho}$, however, is fully allocated to each exposure through marginal cost pricing, with each unit of allocated risk being charged the frictional cost $\tau$. Second, if the total risk constraint always binds, then total risk costs tally up to $(\tau + \sum_{i=1}^{m} \lambda_i) K$, which is naturally interpreted as a cost of capital (in parentheses) times total capital. In intermediate cases, the risk cost that is allocated is the expected total risk assumed times the frictional cost, $\tau \bar{\rho}$, plus the total shadow costs of risk capital,
Thus, marginal cost has a capital allocation interpretation that “adds up.”

It is important to contemplate the nature of the allocation to the first risk. At the time of decision making, the marginal cost of the first risk, and the capital allocated to the first risk, may differ from the marginal cost of that risk after uncertainty associated with \( \alpha \) has been resolved and the portfolio completed. This \textit{ex ante} allocation is an average of possible final cost allocations in future states of the world. To illustrate, by using equations (5) and (6), we see that the \textit{ex ante} cost allocation to the first risk can be expressed as:

\[
\sum_{i=1}^{m} p(\alpha_i) \left[ \tau + \mathbb{E}_i [r_1 \delta] - \tau \frac{\partial \rho(q_0, q_1; \alpha_i)}{\partial q_1} \right] \left[ \frac{\partial \rho(q_0, q_1; \alpha_i)}{\partial q_0} \right].
\]

Thus, for each state, we multiply the probability of state \( i \) times the marginal value of risk capital in state \( i \) (the first bracketed term) times the risk capital allocated to the first risk in state \( i \) (the second bracketed term); the total cost allocation is then the sum of these figures over all states.

A few remarks on the two-period case are in order:

1. Note that if the uncertainty about the second opportunity concerns only the expected return and not the risk properties, then the allocation \( \frac{\partial \rho(q_0, q_1; \alpha_i)}{\partial q_1} q_1 \) will be the same in all states of the world. In other words, capital allocation will not be affected by the uncertainty. This is an artifact of a two-opportunity setup and is not likely to generalize to more than two opportunities.

2. The total marginal cost of risk capital (including the shadow cost) will not generally equal \( \tau \) in every future state. Since capacity is inherited and fixed, the firm will typically face constraints on its risk-bearing, leading the marginal value of risk capital to differ from its carrying cost \( \tau \). To illustrate, the RORAC expression for the first risk can be obtained from equation (??):
The expression on the right hand side is the hurdle rate, which is equal to the expected marginal value of risk capital in future states of the world, gross of the frictional cost \( \tau \). If the total risk bearing constraints were never binding, then the right hand side would collapse to \( \tau \). In general, however, the hurdle rate corresponding to the target return on risk capital will generally be higher than \( \tau \), depending on the extent to which the capacity constraints bind. Extension to multiple opportunities is conceptually straightforward though notationally tedious. We provide this extension in the Appendix.

2.3 Portfolio Optimization in a Markovian Setting

2.3.1 Multiple Risks

Suppose the financial institution with a certain initial wealth \( W \) has access to multiple potential opportunities (projects) from a risk pool. In each period \( t \in \{0, 1, \cdots, n\} \), one of \( m \) possible opportunities becomes available, or no opportunity emerges. We assume the probabilities are independent and identical for each period. More precisely, we assume the probability of opportunity \( i \) emerging is \( p_i \) and, consequently, the probability of no underwriting opportunity is \( p_0 = 1 - \sum_{i=1}^{m} p_i \) for each period.

When one particular opportunity emerges, the firm makes a decision on the amount of risk that it will take on in its portfolio, \( q_i(t) \). Moreover, let \( \pi_i(t) \) represent the total cumulative amount of risk \( i \) in the company’s portfolio acquired until time \( t \). Clearly, we have \( \pi_i(n) = \sum_{t=0}^{n} q_i(t) \) and \( \pi_i(0) = 0 \forall i = \{1, 2, \cdots, m\} \).

Each opportunity generates a certain expected return per unit. In general, this return \( r_i(t, \pi_i(t), q_i(t), W(t)) \) may depend on the time \( t \), quantity of the risk, and the company’s wealth (as measured by initial assets and the expected value of profits associated with underwritten policies) at that time. However, to keep things simple, here we assume the expected return is exogenous \( r_i \). Hence the total wealth at time \( t \) is \( W(t) = W + \sum_{i=1}^{m} r_i \pi_i(t) \).

On the other hand, taking on additional risk will affect the institution’s portfolio risk, which will influence the decision in two ways: 1) The risk corresponds to costly risk capital that the company has to hold, where we assume this amount is given via a risk measure.
and the frictional cost of capital is constant at the rate \( \tau \); 2) the total capital that the company can access is constrained in that it cannot exceed the level \( K \). We also introduce the portfolio risk measure at time \( t \), \( \rho(\pi(t)) \), where \( \pi(t) = [\pi_1(t), \ldots, \pi_m(t)] \).

Therefore, the firm faces the following problem:

\[
\max_{q \in [0, n]} \mathbb{E}[W(n) - \tau \rho(\pi(n))],
\]

subject to:

\[
\rho(\pi(n)) \leq K.
\]

Note that this problem is equivalent to the optimization problem elaborated in the Appendix, which extended the two-period model of Section 2.2 to a multiperiod generalization. The objective function is identical to the objective function (17), and the constraint lines up with equation (18). In words, the firm seeks to maximize the expected profits associated with underwriting while respecting the constraint that total risk capital never exceeds capacity \( K \).

To solve this problem, we write the objective function as a combination of a final risk measure at time \( n \) and cumulative instantaneous revenues, given the initial data \((\pi_0, t_0)\):

\[
V[q, \pi, n](\pi_0, t_0) = \sum_{i=1}^{m} \sum_{s=t_0}^{n} [r_i q_i(s) \mathbb{1}_{\{Risk(s) = i\}}] - \tau \rho(\pi(n)).
\]

(7)

Thus, the expected value function is:

\[
v^*[\pi, t] = \max_{q[t, n]} \left\{ \mathbb{E} \left[ V[q, \pi, n](\pi, t) \bigg| \pi(t) = \pi \right] \right\},
\]

(8)

with the portfolio \( \pi(t) = \pi \) at time \( t \). By the dynamic programming principle, we can rewrite the value function as:

\[
v^*[\pi, t] = \max_{q(t)} \left\{ \mathbb{E} \left[ \max_{q[t, n]} \left( \mathbb{E} \left[ V[q, \pi, n](\pi, t) \bigg| q(t), \pi(t) \right] \right) \bigg| q(t) = q, \pi(t) = \pi \right] \right\}
\]

\[
= \max_{q(t)} \left\{ \sum_{i=1}^{m} p_i r_i q_i(t) + p_i v^*[\pi + q_i(t), t + 1] \right\}.
\]
Thus, in each period $t$, the firm faces $m$ possible problems, depending on the risk $i \in \{1, 2, \cdots, n\}$ that emerges:

$$\max_{q_i(t)} r_i q_i(t) + v^* [\pi + q_i(t), t + 1],$$

subject to:

$$\rho(\pi + q_i(t)) \leq K.$$ 

The capital condition needs to be satisfied only after the decision at the final time $n$. However, at any point in time, there is a non-zero chance that no future opportunities will emerge. Thus, the constraint indeed has to be satisfied at every time $t$.

Solving the first order conditions of the above problem, we obtain the decision for each risk $i$ at each period $t$ from the implicit function:

$$r_i = \frac{\partial v^* [\pi + q_i(t), t + 1]}{\partial q_i(t)}, \quad (9)$$

assuming this decision $q_i(t)$ does not violate the risk constraint $\rho(\pi + q_i(t)) \leq K$. Embedded in (9) is a notion of risk capital cost allocation, which is more easily grasped by using (7) and (8) to rewrite as:

$$r_i = \tau \mathbb{E} \left[ \frac{\partial \rho(\pi(n))}{\partial q_i(t)} \bigg| \pi(t) = \pi \right],$$

which we write, for purely pedagogical purposes, under the assumption that $\pi(n)$ reflects the corresponding period maximizers and that the constraint never binds. In this extreme case, the marginal cost of risk can be written as the frictional cost of risk capital $\tau$ times an allocation of capital per unit of exposure (the bracketed term on the right-hand side). For the more general case where the constraint binds in some states of the world, the result (22) in the Appendix yields:

$$r_i = \mathbb{E} \left[ (\tau + \lambda) \frac{\partial \rho(\pi(n))}{\partial q_i(t)} \bigg| \pi(t) = \pi \right],$$

where $\lambda$ is a random variable reflecting the value of relaxing the risk measure constraint in every possible future state of the world. Thus, the current marginal return on an investment
is again equated to an expected product of a marginal cost of risk capital \((\tau + \lambda)\) and a marginal allocation of risk capital.

### 2.3.2 Numerical Illustration: A Two Risk Problem

Suppose the investor has the opportunity to invest in two independent risks, each having an expected return \(r_i, i = 1, 2\). In each period \(t \in \{0, 1, \cdots, n\}\), there are three possibilities: 1) risk 1 emerges with a probability \(p_1\), 2) risk 2 emerges with a probability \(p_2\), or 3) neither of the risks emerges with a probability \(p_0 = 1 - p_1 - p_2\). The homogeneous risk measure we will use in this subsection is the Standard Deviation:

\[
\rho(\pi) = \sqrt{\pi_1^2 \sigma_1^2 + \pi_2^2 \sigma_2^2}.
\]

This is especially convenient for Normal distributed marginals since advanced risk measures have an analogous form (see Embrechts, Frey, and McNeil, 2005). Other risk measures can be considered similarly. Several general features of this problem are worth observing.

First, it is possible for investment to be trivially zero if the cost of risk capital is too high. Specifically, it can be shown that zero investment will be optimal if \(\tau^2 > \frac{r_1^2}{\sigma_1^2} + \frac{r_2^2}{\sigma_2^2}\), even if we removed uncertainty from the problem and allowed the investor to set exposures to both risks without constraint.

Second, assuming that positive investment can be supported (i.e., if \(\tau^2 < \frac{r_1^2}{\sigma_1^2} + \frac{r_2^2}{\sigma_2^2}\)), neither risk is viable on its own if:

\[
\tau^2 > \max \left\{ \frac{r_1^2}{\sigma_1^2}, \frac{r_2^2}{\sigma_2^2} \right\}. \tag{10}
\]

Profitability in this case depends on combining the risks to take advantage of diversification. Thus, when the first opportunity presents itself, the investor’s calculus in deciding on the amount to invest depends crucially on the chances of the second opportunity emerging. It should be noted that this diversification calculus may drive decisions in a different direction than the real option effect typical in sequential investment problems: Real option logic typically encourages the investor to delay investment and wait for better opportunities early.
in the process, while becoming more aggressive later in the process when fewer opportunities remain. Diversification logic, on the other hand, encourages the investor to stake out large initial positions early in the game, when diversification opportunities are likely to arrive later on, but be more cautious later on the game, when those diversification opportunities are less likely to ever come.

Finally, if the investor faced no uncertainty and were allowed to set the exposures freely, the optimal ratio of investment is given by:

\[
\frac{\pi_1}{\pi_2} = \frac{r_1 \sigma_2^2}{\sigma_1^2},
\]

which, together with the total risk constraint:

\[
\rho(\pi) = \sqrt{\pi_1^2 \sigma_1^2 + \pi_2^2 \sigma_2^2} \leq K,
\]

can be used to determine the best possible combination of investments that could possibly be achieved by the investor.

We seek numerical solutions of the dynamic optimization problem by implementing the Bellman equation from Section 2.3.1. If opportunity \( i \) emerges, the optimization problem is (for \( i = 1, 2 \)):

\[
\max_{q_i(t)} \{ r_i q_i(t) + v^* [\pi + q_i(t), t + 1] \},
\]

subject to:

\[
\sqrt{\pi_1^2 \sigma_1^2 + \pi_2^2 \sigma_2^2} \leq K.
\]

If the two risks are dependent, then the standard deviation will take the form:

\[
\rho(\pi) = \sqrt{\pi_1^2 \sigma_1^2 + \pi_2^2 \sigma_2^2 + \phi \sigma_1 \sigma_2 \pi_1 \pi_2},
\]

where \( \phi \) is the correlation between the risks, so the constraint can be modified to:

\[
\sqrt{\pi_1^2 \sigma_1^2 + \pi_2^2 \sigma_2^2 + \phi \sigma_1 \sigma_2 \pi_1 \pi_2} \leq K.
\]
2.3.3 Numerical Approach

In the numerical approach, we solve the dynamic optimization problem backwards. For the last period $n$, we can analytically solve the optimization problem for each of the three possible opportunities that may emerge, and obtain the expected value function. More details of the solution are shown later in this section. For each previous period, we look for the optimal amount of investment for each possible risk among a set of possible investment levels to maximize the sum of the return on the new investment and the next period’s expected value function. Specifically, in each period, we need to find the optimal new investments $q_1^*$ or $q_2^*$ for all possible initial risk exposure levels $\pi_1$ and $\pi_2$.

We solve the problem using a grid-based approach with discrete support. First, we find the possible range of risk exposures, from zero to the amount that binds the risk constraint without exposure to the other risk, i.e., $K/\sigma_1$ and $K/\sigma_2$. Then, we parse each risk exposure range into an equally spaced set of points, with $s_1$ being the number of points for the first risk and $s_2$ the number for the second. These sets of points constitute the possible investments in the decision set. The finer the grid, the more possible investment decisions we provide, and the more accurate is the approximation. Optimal choices must respect the risk capital constraint, so that admissible $\pi_1$ and $\pi_2$ have to satisfy $\sigma_1^2 \pi_1^2 + \sigma_2^2 \pi_2^2 \leq K^2$. As a result, we have a 2-dimensional grid (matrix) of investment levels where the admissible part resembles an upper triangle.

We now illustrate the mechanics of the approach for a case where (10) holds, so that profitability depends on diversification. For the final period $n$, if no risk emerges, then the value matrix is calculated by $v^*(\pi, n|0) = -\tau \sqrt{\pi_1 \sigma_1^2 + \pi_2 \sigma_2^2}$, where $\pi_1$ and $\pi_2$ exist for the admissible grid. If risk 1 emerges, first we calculate a candidate for the optimal level of exposure to the first risk, conditional on the fixed exposure to the second risk and ignoring the constraint, by solving the first order condition for $q_1^*$:

$$\pi_1 + q_1^* = \frac{(r_1/\sigma_1^2)\sigma_2 \pi_2}{\sqrt{\tau^2 - r_1^2/\sigma_1^2}}.$$  

In cases where negative investment is possible, the initial exposure to a risk will not affect the optimal investment in that risk. This will be discussed in greater detail in Section 2.3.4.
Then we consider the risk measure constraint, so we update the new $\pi_1$ matrix by:

$$\pi_1 + q_1^* = \frac{1}{\sigma_1} \sqrt{K^2 - \sigma^2_2 \pi^2_2},$$

for those locations where $\sigma^2_1 \pi^2_1 + \sigma^2_2 \pi^2_2 > K^2$. The constraint will bind in circumstances where:

$$\pi_2 \leq \frac{K}{\tau \sigma_2} \sqrt{\tau^2 - r^2_1 / \sigma^2_1}.$$

The calculations are analogous if risk 2 emerges. Therefore, we can calculate the conditional value matrices as:

$$v^*[\pi, n | i] = \begin{cases} -\sigma_j \pi_j \sqrt{\tau^2 - r^2_i / \sigma^2_i} - r_i \pi_i & \text{if } \pi_j \leq \frac{K}{\tau \sigma_j} \sqrt{\tau^2 - r^2_i / \sigma^2_i}, \\ \frac{r_i}{\sigma_i} \sqrt{K^2 - \sigma^2_j \pi^2_j - \tau K - r_i \pi_i} & \text{if } \pi_j > \frac{K}{\tau \sigma_j} \sqrt{\tau^2 - r^2_i / \sigma^2_i}. \end{cases}$$

Hence, the expected value matrix is:

$$v^*[\pi, n] = p_1 v^*[\pi, n | 1] + p_2 v^*[\pi, n | 2] + p_0 v^*[\pi, n | 0].$$

Once we have the value matrix, we can proceed to analyze the previous period and work backwards through time: For each period before $n$, we know the value function of the next period, and based on the next period’s value matrix, we find the optimal decisions in the current period, and subsequently the expected value matrix of this period. For example, at period $n - 1$, we know the expected value matrix at period $n$ is $v^*(\pi, n)$, and we will use it to find the optimal $q_1(n - 1)$ and $q_2(n - 1)$, as well as the expected value matrix $v^*(\pi, n - 1)$.

If no risk emerges, the value matrix is:

$$v^*[\pi, n - 1 | 0] = v^*[\pi, n].$$

If risk $i$ emerges, the investor’s problem is:

$$\max_{q_i(n-1)} r_i q_i(n - 1) + v^*[\pi + q_i(n - 1), n],$$

18
which is equivalent to:

$$\max_{q_i(n-1)} r_i \pi_i(n) + v^* [\pi(n), n] - r_i \pi_i(n - 1).$$  \hspace{1cm} (13)$$

We determine the corresponding maximizers by a grid search over the discrete choice set. More precisely, in the case where positive and negative adjustments are permissible, for each given value of $\pi_j$, we solve for the optimal $\pi_i$, $j \neq i$, and subtract the current level according to Equation (13). In the case of nonnegative investments, we additionally check whether the optimal choice is admissible—and choose the boundary value otherwise.

### 2.3.4 Base Case

We start by considering the case of independence and allow investments to be partially reversible in the sense that the investor can choose negative exposure to an opportunity if and when it arises. Our “base case” thus considers two independent risks, and investments can be negative.

<table>
<thead>
<tr>
<th>Name</th>
<th>Meaning</th>
<th>Value</th>
</tr>
</thead>
<tbody>
<tr>
<td>$\tau$</td>
<td>cost of risk capital</td>
<td>4.5</td>
</tr>
<tr>
<td>$K$</td>
<td>maximum risk capital</td>
<td>60</td>
</tr>
<tr>
<td>$r_1$</td>
<td>expected return of risk 1</td>
<td>9</td>
</tr>
<tr>
<td>$r_2$</td>
<td>expected return of risk 2</td>
<td>8</td>
</tr>
<tr>
<td>$\sigma_1$</td>
<td>standard deviation of risk 1</td>
<td>3</td>
</tr>
<tr>
<td>$\sigma_2$</td>
<td>standard deviation of risk 2</td>
<td>2</td>
</tr>
<tr>
<td>$p_1$</td>
<td>probability of opportunity 1</td>
<td>0.5</td>
</tr>
<tr>
<td>$p_2$</td>
<td>probability of opportunity 2</td>
<td>0.3</td>
</tr>
<tr>
<td>$p_0$</td>
<td>probability of no opportunity</td>
<td>0.2</td>
</tr>
<tr>
<td>$n$</td>
<td>total periods</td>
<td>8</td>
</tr>
<tr>
<td>$\phi$</td>
<td>correlation of two risks</td>
<td>0</td>
</tr>
<tr>
<td>$s_1$</td>
<td>number of possible investments in risk 1</td>
<td>2000</td>
</tr>
<tr>
<td>$s_2$</td>
<td>number of possible investments in risk 2</td>
<td>3000</td>
</tr>
</tbody>
</table>

We select parameters in Table 1 to insure that Condition (10) is satisfied so that diversification is essential. Risk 1 has higher return with a higher standard deviation and a higher probability of arrival. We consider an 8-period model.

First, we investigate the relationship between the decision on risk 1 given an initial risk
2 exposure $\pi_2$, given that risk 1 is emerging. Since in the base case, negative investment is allowed, the initial risk 1 exposure $\pi_1$ will not affect the total optimized amount of risk 1 exposure, $\pi_1 + q_1^*$, at the end of each period. We analyze how the decision curve changes with time, as shown in Figure 1.

Figure 1: Optimal investment decisions in risk 1, $\pi_1 + q_1^*$, with different initial $\pi_2$

The vertical axis measures $\pi_1 + q_1^*$, the decision on risk 1 given that risk 1 emerges, as a function of the amount of risk 2 exposure (shown on the horizontal axis) at the beginning of different periods. The different lines show how the decision changes from the last period (dashed line) to the first period (solid line).

In this setting, given the risk capital constraint of 60, the best possible investment levels are $\pi_1^b = 12$ and $\pi_2^b = 24$. From this figure, we can see that the optimal choice $\pi_1 + q_1^*$ is set very close to this best possible level, regardless of the given level of risk 2 exposure, during early periods when the constraint is not binding. At high levels of risk 2 exposure, beyond the best-possible level of 24, the constraint forces the choice for $\pi_1 + q_1^*$ below the best-possible level of 12; however, such high levels of risk 2 exposure could only occur if they were inherited, as they would never be chosen by the investor. In later periods, the optimal choice for $\pi_1 + q_1^*$ drops at low levels of risk 2 exposure. At higher levels of risk 2 exposure, in the 20 to 24 range, the optimal choice for $\pi_1 + q_1^*$ rises above the best-possible
level in the latest periods.

The intuition is fairly straightforward. Early on, the investor aims for the best-possible outcome, as there is plenty of time for the second risk to emerge, and, even if it does not, it is likely that the investor will have an opportunity to reverse the position later on through negative investment in risk 1. In the later periods, however, the possibility that the investor will not get another chance to adjust her exposure to either risk looms much larger in her calculus. As a result, she moves in the direction of assuming that the current level of risk 2 exposure will remain at that level, and the choice for $\pi_1 + q_1^*$ is therefore optimized relative to that level of risk 2 exposure. The latter late-period behavior can lead to investment in the first risk that is lower than the best-possible level if risk 2 exposure is either low or above 24 (in which case investment is made to the point where the risk constraint is binding). The late-period behavior can also lead to investment greater than the best-possible level of 12 when risk 2 exposure is close to, but short of 24; in this circumstance, the investor takes up remaining capacity that would ideally be dedicated to risk 2 if more time remained.

![Optimal investment decision in risk 1, $\pi_1 + q_1^*$, changing with time periods, given initial $\pi_2$](image)

**Figure 2:** Optimal investment decisions in risk 1, $\pi_1 + q_1^*$, with different time periods

Figure 2 presents this information from another angle, showing how the risk 1 decision varies by time periods, for different levels of given risk 2 exposure. The horizontal axis
shows time from period 1 to 8, and the vertical axis displays the investment decision on risk 1 given that it arrived. As the lines get thinner, the given level of \( \pi_2 \) increases from 0 (the thickest line) to the level of 22.5 (the thinnest line).\(^4\)

As time progresses, it becomes more difficult to adjust positions, so the investment in risk 1 is pushed toward the optimal level for diversifying purposes (that is, the optimal level conditional on the current, though potentially nonoptimal, level of exposure to risk 2). For small levels of risk 2, the optimal investment on risk 1 is decreasing in time, while for high enough (though suboptimal) levels of risk 2, investment can increase in time as capacity that was reserved for risk 2 is soaked up by risk 1 in later periods. The key time period appears to be time period 4: In period 4 and prior, the investor chooses the best-possible level for risk 1, while the dream of perfection—if it has not been achieved—is abandoned in favor of compromise starting in period 5.

### 2.3.5 Dependent Risks

We now introduce correlation between the two risks. The six panels of Figure 3 show how the decisions change with time at correlations of 0, 0.3, 0.4, 0.5, 0.6, 0.8, and 0.9.

The basic story is largely the same. As correlation \( \phi \) increases from 0 to 0.5, the best-possible level of investment on risk 1 falls, but the firm still aims for perfection in the early periods on the assumption that adjustments can be made at a later date. Later periods push investment toward the optimal level for diversification purposes, given the level of exposure to risk 2. If correlation increases enough, investment is no longer profitable, and the investor will aim for zero investment in both lines. If the investor has inherited an exposure to risk 2 that she has been unable to shed in the earlier periods, diversifying investments in risk 1 become optimal. This situation appears in this example with correlations above 0.5, as can be seen in Figure 3.

\(^4\)The highest-possible level of \( \pi_2 \) is 24. When \( \pi_2 \) takes values in excess of 24, the optimal decision on risk 1 exposure is driven lower to satisfy the constraint. We show decisions with a maximum of \( q_2 = 22.5 \), corresponding to 75% of the maximum exposure to risk 2 in the grid, and similar rules are applied in the later figures.
2.3.6 Nonnegative Investments

Restricting new investments to be nonnegative changes the early period calculus considerably. In the base case with unrestricted investment, the investor aimed for perfection in early periods with the knowledge that she would likely be able to reverse the investment if the diversification opportunity did not materialize. Making the investments irreversible eliminates the fall-back option.

The previously described numerical method is easily adapted to this case. For example, after we find a candidate for the optimal investment level in risk 1, we need to compare it with the current risk 1 exposure: if the candidate decision involves a decrease in the investment level, it will violate the nonnegativity rule, so the firm keeps the current investment on risk 1.

We now add the nonnegativity constraint to the base case. Introducing irreversibility complicates the visualization of results, since it makes the optimal decision for risk 1 depend on the current levels of exposures to both risk 1 and risk 2. Consequently, we cannot draw the decision structure over various periods (or various risk 2 exposures) in multiple curves.

Figure 3: Optimal decision changes with time periods for different correlations
on a 2-dimensional figure. To address this, we present results for a given risk 1 exposure of approximately 4 (corresponding to 20% of the maximum exposure to risk 1 in the grid).

Figure 4 shows, given this initial risk 1 exposure, how optimal investment in risk 1 varies with an initial risk 2 exposure (displayed on the x-axis). The individual lines in the graph correspond to different time periods, with time shifting from late periods in dash line to early periods in more solid line. The impact of irreversibility is seen when comparing the early period decisions in Figure 4 with their counterparts in Figure 1. Investments in risk 1 in early periods are much smaller in the presence of irreversibility, as the possibility of being stuck with an undiversified investment looms larger in the profit calculus. This is also evident in Figure 5, which displays investment in risk 1 as a function of time period, with the various lines corresponding to different levels of initial risk 2 exposure, with the thinner lines indicating higher levels of initial exposure. In Figure 2, with reversibility, all levels of initial risk 2 exposure were associated with the same level of risk 1 investment in early periods, as the investor aimed for the best possible portfolio. In contrast, Figure 5 shows that progressively lower levels of initial risk 2 exposure are associated with progressively lower levels of risk 1 investment, even in early periods, as the investor must hedge the
2.3.7 Illustrating the Real Option Effect

The previous numerical examples all are driven primarily by the imperative of diversification, and this imperative yields decision rules that are somewhat unusual for sequential investment problems. The typical “real option” logic stresses patience early in the game, as the possible arrival of better opportunities leads to higher early period hurdle rates and more cautious early investment decisions than would be predicted by standard internal rate-of-return models. Diversification motives, on the other hand, dictate the opposite behavior: Early investment decisions are more aggressive than later ones, as greater amounts of remaining time offer richer opportunities for diversification.

The “real option” effect—of restraining early investment to “leave room” for more attractive opportunities—can also be recovered in numerical analysis. To illustrate this effect, we consider several modifications to the base case. In addition to the modification of the parameters, which is shown in Table 2, we consider irreversible investment and demonstrate the decision curve with initial risk 1 exposure of approximately 4 as we did in Section 2.3.6.

We first consider, in Case 1, the situation where risk 1 is relatively infrequent (with
Table 2: Parameters for Illustrating Real Option Effect

<table>
<thead>
<tr>
<th>Parameter</th>
<th>Case 1</th>
<th>Case 2</th>
<th>Case 3</th>
<th>Case 4</th>
</tr>
</thead>
<tbody>
<tr>
<td>$\tau$</td>
<td>3</td>
<td>3</td>
<td>3</td>
<td>3</td>
</tr>
<tr>
<td>$K$</td>
<td>60</td>
<td>60</td>
<td>60</td>
<td>60</td>
</tr>
<tr>
<td>$r_1$</td>
<td>18</td>
<td>8</td>
<td>18</td>
<td>8</td>
</tr>
<tr>
<td>$r_2$</td>
<td>8</td>
<td>18</td>
<td>8</td>
<td>18</td>
</tr>
<tr>
<td>$\sigma_1$</td>
<td>3</td>
<td>2</td>
<td>3</td>
<td>2</td>
</tr>
<tr>
<td>$\sigma_2$</td>
<td>2</td>
<td>3</td>
<td>2</td>
<td>3</td>
</tr>
<tr>
<td>$p_1$</td>
<td>0.15</td>
<td>0.33</td>
<td>0.15</td>
<td>0.33</td>
</tr>
<tr>
<td>$p_2$</td>
<td>0.33</td>
<td>0.15</td>
<td>0.33</td>
<td>0.15</td>
</tr>
<tr>
<td>$p_0$</td>
<td>0.52</td>
<td>0.52</td>
<td>0.52</td>
<td>0.52</td>
</tr>
<tr>
<td>$n$</td>
<td>8</td>
<td>8</td>
<td>8</td>
<td>8</td>
</tr>
<tr>
<td>$\phi$</td>
<td>0</td>
<td>0</td>
<td>0.8</td>
<td>0.8</td>
</tr>
<tr>
<td>$s_1$</td>
<td>2000</td>
<td>2000</td>
<td>2000</td>
<td>2000</td>
</tr>
<tr>
<td>$s_2$</td>
<td>3000</td>
<td>3000</td>
<td>3000</td>
<td>3000</td>
</tr>
</tbody>
</table>

the probability of emergence reduced from 0.5 to 0.15) but highly profitable (with a return doubled from 9 to 18). Risk 2 has similar parameters to those from the base case. We also modify the cost of capital $\tau$ from 4.5 to 3 so that each investment itself is profitable and diversification is not necessary for investment, although diversification is still beneficial. The best possible outcome is $\pi^*_1 = \pi^*_2 = 60/\sqrt{13} \approx 16.64$.

Figure 6 shows how the optimal investment in risk 1 evolves across time periods, with the individual lines representing different levels of given risk 2 exposure, with thinner lines representing higher levels of exposure.

From the figure, we can see that the risk 1 decision is increasing with time when the risk 2 exposure is small. In early periods, the firm targets an ideal level of investment, under the assumption that it will be able to diversify with risk 2. As time progresses, this hoped for situation is less likely to emerge, so it just soaks up more of its capacity with the first risk. This increasing decision rule is an illustration of the real option effect working in conjunction with the diversification effect. We show the results with initial risk 1 exposure at approximately 4, which is considerably lower than the best possible level 16.64.

Next, in Case 2, we reverse the relative positions of the two risks and look at the case where risk 1 is frequent and slightly profitable while risk 2 is infrequent and highly profitable. In other words, we exchange the probability and profitability parameters of risk 1 and 2. Figure 7 again shows how the optimal investment in risk 1 evolves across time periods, with
the individual lines representing different levels of given risk 2 exposure, with thinner lines representing higher levels of exposure. In this case, the best possible investment is again $\pi_1^* = \pi_2^* \approx 16.64$, the same as in Case 1.

The real option effect now appears more clearly. In the early periods, investment in the less profitable risk 1 is initially set at a level to accommodate a large investment in the more profitable risk 2. As time progresses and the arrival of risk 2 becomes less likely, the investor settles by soaking up remaining capacity with risk 1. While this capacity would ideally be devoted to the more profitable risk, using it on the less profitable risk is better than failing to use it at all.

Comparing Figure 6 and Figure 7, we find that in early periods, decisions are close to the first best investment. As time goes by, investments push beyond the first best level when risk 2 exposures are low, and the possibility that a risk 2 investment will never arrive starts to loom larger. The change is more dramatic in Case 2, as more room is left for the more highly profitable risk. In Case 1, the other opportunity is less important, and the firm starts investment in the profitable first risk at a relatively higher level in early periods.

We also investigate two more cases, which are slightly modified from Cases 1 and 2. In Case 3 and 4, we change the correlation from 0 to 0.8. In this circumstance, the diversifi-
Figure 7: Optimal investment for low return and high frequency risk

Figure 8: Decisions with various correlation, capital cost, profitability, and frequency
cation benefit becomes low. In Case 3, heavy investment is made in the highly profitable risk as soon as it appears; little room is left for the second risk, as it offers only modest diversification benefits. The slope of investment over time is thus slight. In contrast, Case 4 studies the decision on the less attractive risk. Significant room is left in hope for the arrival of the highly profitable risk, and the slope over time is even steeper than in Case 2.

2.4 Concluding Remarks

Reinsurers, private equity firms, and other financial institutions investing in illiquid opportunities must take into account the expected risk-return profile of future opportunities when making current investments. Current capital allocation methods, which are largely developed in static full information settings, must be adjusted to this reality. RORAC evaluation of investments in this setting must consider an average of possible future capital allocations, rather than a single capital allocation based on a pro forma portfolio.

We have shown that such an adjustment is feasible if the uncertainties are understood. Capital allocation can proceed in a generalized form, with risk pricing reflecting averages of capital allocations in the future. Failure to explicitly model uncertainties about future opportunities can lead to misstatement of the marginal cost of risk, and, as a result, misallocation of capacity in current opportunities.

In numerical exercises, we show that the portfolio aspects of the problem introduce complexities into the economic assessment of this sequential investment problem. Consistent with the intuition of the real options literature, we find that the explicit consideration of uncertainty should lead firms to reduce investment in current opportunities and leave capacity for attractive future opportunities should they appear. However, diversification motivations can either reinforce the “waiting” effect or counteract it, as the firm anticipates the likely profitability of a current opportunity before a complete portfolio has been constructed. Specifically, a firm may invest more heavily in an opportunity presented early, as it will have ample chance to exploit its full potential by making use of subsequent diversification opportunities; that same opportunity attracts less interest late in the investment cycle, as the firm is no longer certain that it will be able to diversify.
3 Egalitarian Equivalent Capital Allocation

This section is a working paper of Kamiya and Zanjani (2016).

3.1 Motivation

Mainstream risk capital allocation methods in financial institutions are grounded in the concept of the marginal cost of risk. Specifically, capital is allocated to each risk in a portfolio based on how much capital is consumed when that risk is expanded at the margin. Such approaches have obvious merit in the context of portfolio optimization, where correct pricing of marginal units of exposure is essential.

Other applications of capital allocation, however, may require fundamentally different methods. One such application is the case where capital must be allocated but the portfolio of risk is fixed. This can occur in insurance markets when a closed block of insurance business is reinsured, or when a runoff company is capitalized or recapitalized.\(^5\) In such cases, allocating capital based on how it is consumed when risk is expanded at the margin is no longer economically relevant. Instead of devising allocation rules to prices which guarantee that the right amount of risk is taken conditional on capitalization, as existing methods are designed to do, we must devise rules to guarantee equitable treatment of participants in the course of choosing optimal capitalization.

Existing methodologies, which allocate the total cost of capital based on how the marginal unit is consumed, can introduce a wedge between individual and collective interests. In particular, individual policyholders which are intensive consumers of the marginal capital unit at the social optimum may be better off with lower levels of capitalization when the total capital cost allocation is being keyed to the consumption of the marginal unit. This relates closely to the notion of stability in allocations: If allocations are unstable with respect to small perturbations, then small changes in risk, capitalization, or in risk measure thresholds can produce large swings in policyholder welfare—which can cause individual policyholders to disagree on the optimal level of capitalization.

This paper is concerned with the latter problem. Specifically, we study how capital cost

\(^5\)A particularly vivid example of a runoff capitalization is provided by Equitas—which is in the process of discharging the liabilities of multiple Lloyd’s syndicates following the market restructuring of 1993.
sharing rules can be designed to guarantee Pareto optimal capitalization acceptable to the various policyholders whose exposures make up the portfolio. We resolve the problem of instability by appealing to the concept of cost monotonicity used in the economic theory of public goods—where cost sharing rules are restricted to produce allocations in a way that no agent will object to the introduction of an improvement to the cost technology.

3.1.1 Background

Many capital allocation methods ultimately boil down to the gradient of a risk measure. Examples include Myers and Read (2001), Denault (2001), Tsanakas and Barnett (2003), Tasche (2004), Kalkbrener (2005), and Powers (2007). Economic justification for the gradient method can be recovered in profit maximization problems where the risk measure serves to constrain risk taking (e.g., Zanjani, 2002; Meyers, 2003; Stoughton and Zechnar, 2007). In the latter papers, the gradient of the risk measure accurately reflects the marginal cost of risk, so allocating capital according to the risk measure gradient is consistent with marginal cost pricing.

Consistency with marginal cost seems desirable, but it is important to understand that such consistency does not grant universal application of the allocation method. Merton and Perold (1993) proved that risk capital allocation would generally fail to provide accurate pricing of inframarginal or supramarginal changes to a risk portfolio. Hence, allocating capital according to the gradient method can yield accurate pricing of marginal changes to a risk portfolio, but no more. Applications where the risk portfolio is fixed may require a different approach. Rather than asking how much risk to take, given fixed capital, sometimes one is confronted with the question of how much capital to hold, given fixed risk.

The latter problem fits squarely within the public goods literature, and in particular those papers concerned with cost-sharing mechanisms for providing the optimal amount of the public good. In the case of the insurance company, the public good is capital. The

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6Bauer and Zanjani (2013) provide a review of gradient methods as well as alternative approaches to capital allocation.

7Although this paper is concerned with an economic approach to capital allocation, it should also be acknowledged the economic approach—in the sense of taking profit or welfare maximization as the guiding objective—is by no means the only approach to capital allocation. Examples of optimization approaches with different objectives can be found in Dhaene, Goovaerts, and Kaas (2003), Laeven and Goovaerts (2004), and Dhaene, Tsanakas, Valdez, and Vanduffel (2012).
policyholders of the company are the consumers, who all enjoy access to the protection afforded by the capital of the firm.

The classic solution to the problem of public good cost sharing is provided by Lindahl (1958), whose basic idea was to derive “personalized prices” that each consumer could pay for the good. These prices were based on each consumer’s marginal utility associated with the public good at the optimum. This idea was subsequently refined and extended by Foley (1970), Kaneko (1977), and Mas-Colell and Silvestre (1989)—who established, among other things, various conditions to guarantee that the solution was Pareto optimal and part of the core.

Cost-sharing based on valuation of the marginal unit, however, can lead to unappealing and unstable outcomes. In particular, one can construct examples (one of which is presented in a later section) where small changes in the level of public good production yield large changes in the cost allocation. In other words, while the Lindahl solution yields a Pareto optimal outcome, the mechanics of the cost sharing can lead some consumers to prefer super-optimal or sub-optimal production levels in cases where a deviation significantly alters the cost allocation. A similar technical problem surfaces in the capital allocation literature. Previous research has recognized the possibility that allocations might not be stable (e.g., Myers and Read, 2001; Zanjani, 2010) to small perturbations of the portfolio or capitalization level.

In the context of the general public goods literature, Moulin (1987) introduced an additional restriction on cost sharing dubbed cost monotonicity aimed at this problem. He argued that a cost sharing mechanism should satisfy the property that all consumers would benefit from a technological improvement in the cost function. This additional restriction, in conjunction with some other conditions on preferences and technology, leads to a unique solution: Specifically, the cost sharing mechanism ends up adhering to what Moulin dubbed egalitarian equivalent cost sharing of a public good. This sharing rule allocates cost so that each consumer’s resulting utility matches her egalitarian equivalent utility level. The consumer’s egalitarian equivalent utility level is the utility she would have received at the maximum level of public good production that results in a feasible utility distribution, if the public good were being given away for free.
We adapt this idea to the context of the capital allocation problem in insurance, showing that the egalitarian equivalent approach to cost sharing yields stable capital allocations. The capitalization solution, moreover, is Pareto optimal, and participation in the scheme is individually rational.

The rest of this paper is organized as follows. Section 3.2 sets up the insurance capital allocation problem, defines the notion of egalitarian equivalent capital allocations, and shows that the resulting allocations are Pareto optimal, cost monotonic, and individually rational. Sections 3.3-3.4 provides a numerical example demonstrating the stability of the egalitarian equivalent allocations in a situation where traditional methods yield unstable allocations. Section 3.5 concludes.

3.2 Insurance Capitalization and Cost Allocation

We consider a set of \( N \) consumers. Each consumer is endowed with \( w^i \) and exposed to a random loss variable \( L^i \). Each consumer has a contract with the same insurance company promising some non-negative level of indemnification in the event of loss, denoted \( I^i \).\(^8\) The indemnification level could be full or partial, but is assumed to be less than the amount of the loss. The recovery from the insurance company may turn out to be less than promised. The company has non-negative assets \( a \) which could be less than total claims, so the consumer’s recovery is:

\[
R^i = \min \left[ I^i, \frac{a}{\sum_{j=1}^{N} I^j} I^j \right].
\]

(14)

The premium paid by the consumer is denoted by \( p^i \), and we require premiums to cover costs associated with capitalizing the firm. Total costs are assumed to consist of actuarial costs plus a frictional cost \( c(a) \), so that in aggregate:

\[
\sum_{i=1}^{N} p^i = \sum_{i=1}^{N} \mathbb{E}R^i + c(a).
\]

Consumer utility is determined by von Neumann-Morgenstern expected utility, which we

\(^8\)Note that the contracted indemnity here is taken as a given. For analysis of the optimal level of indemnity, see Zanjani (2010) and Bauer and Zanjani (forthcoming).
will take to be continuous with risk aversion:

$$\mathbb{E}u^i(w^i - p^i - L^i + R^i).$$

The premium paid by the consumer, $p^i$, can be decomposed further into the actuarial loss and an amount to cover the frictional costs of assets:

$$p^i = \mathbb{E}R^i + z^i$$

so that we may write utility as a function of the asset level (the public good) and a cost share:

$$V^i(a, z^i) = \mathbb{E}u^i(w^i - L^i + R^i - \mathbb{E}R^i - z^i).$$

with the restriction that the cost allocations pay for the (frictional) cost of public good production:

$$\sum_{i=1}^{N} z^i = c(a).$$

where we take the frictional cost function to be increasing and continuous.\(^9\)

We write the set of feasible allocations as:

$$\Omega = \left\{(a, z^1, \ldots, z^N) | a \geq 0, \sum_{i=1}^{N} z^i = c(a) \right\}.$$

### 3.2.1 Asset Level Selection and Cost Sharing Mechanisms

A mechanism $M$ assigns to each cost function a level of public good production and a set of cost shares satisfying (16):

$$M(c, V^1, \ldots, V) = (a_m(c), z_m^1(c), \ldots, z_m^N(c))$$

We are interested here in two key properties of a mechanism:

\(^9\)We have expressed frictional costs as a function of assets rather than capital, but note that this form is flexible enough to capture frictional capital costs. For example, consider: $c(a) = \hat{c}(a - \mathbb{E}R^i)$, where $\hat{c}$ is a continuous and increasing function and capital is the difference between assets and expected liabilities ($a - \mathbb{E}R^i$). Notice that capital is a continuous and increasing function of assets, so that $c(a)$ will inherit continuity and monotonicity as well.
1. Pareto optimality - Does the mechanism select a Pareto optimal allocation for every cost function?

2. Cost Monotonicity - A mechanism satisfies cost monotonicity if, for any two cost functions $c_1$ and $c_2$ we have:

$$c_1(a) \leq c_2(a) \quad \forall a \geq 0 \implies V^i(a(c_1), z^i_m(c_1)) \geq V^i(a(c_2), z^i_m(c_2)) \quad \forall i \in \{1, \ldots, N\}.$$ 

These properties are less than typically required in the public good literature on cost sharing (e.g., Kaneko, 1977; Mas-Colell and Silvestre, 1989), which usually also requires allocations to be in the core (as described by Foley, 1970) of allocations that can’t be improved upon by coalitions of consumers. The core concept is natural in cases where the public good is non-rival, but in the insurance case all consumers are rival claimants on the same assets. Contemplating sub-coalitions of consumers in this case would thus involve alteration of preferences over the public good, as removal of potential claimants affects prospective consumption by the remaining consumers. Consistent with our motivating examples, we restrict our attention to the case where consumers cannot leave the company and thus do not require the allocation to be coalition-proof.

Cost monotonicity was introduced by Moulin (1987), motivated by requiring any cost sharing mechanism to allocate responsibility in such a manner that “no agent will oppose the implementation of a technological advance.” As will become clear in the example of the next section, this requirement is intimately related to the notion of stability in capital allocations: If a mechanism has a tendency to produce allocations that are unstable with respect to small changes in capitalization, it is not likely to be cost monotonic.

### 3.2.2 Egalitarian Equivalent Capital Cost Allocation

Moulin (1987) also introduced the mechanism of egalitarian equivalent cost allocation, an approach he showed to be consistent with cost monotonicity. His idea was to allocate cost responsibility so that the resulting distribution of utility would match the distribution associated with the egalitarian equivalent level of public good production—which he defined
as the highest possible level of the public good that, if it were provided for free to consumers, would yield a feasible utility distribution.

In our case, the egalitarian equivalent level of assets $a^*$ is the highest level of assets that would yield a feasible utility distribution, if the policyholders did not have to pay for the frictional costs associated with those assets:

$$a^* = \sup \{ \hat{a} \geq 0 | \exists (a, z^1, \ldots, z^N) \in \Omega : V^i(\hat{a}, 0) \leq V^i(a, z^i) \quad \forall i \in \{1, \ldots, N\} \}.$$ 

Moreover, given an egalitarian equivalent level of assets $a^*$, we call any feasible allocation $(\bar{a}, \bar{z}^1, \ldots, \bar{z}^N)$ satisfying:

$$V^i(a^*, 0) \leq V^i(\bar{a}, \bar{z}^i) \quad \forall i \in \{1, \ldots, N\}$$

an egalitarian equivalent allocation.

The following theorems establish existence, individual rationality, Pareto efficiency, and cost monotonicity of egalitarian equivalent allocations. They are essentially slight modifications of portions of Moulin’s results, adapted to the problem at hand and in particular sidestepping the issue of the core property.

**Theorem 1.** Suppose the loss distributions are bounded and nontrivial and the cost function is strictly increasing and weakly convex. The egalitarian equivalent level of public good production $a^*$ is finite and any egalitarian-equivalent allocation $(\bar{a}, \bar{z}^1, \ldots, \bar{z}^N)$ satisfies:

$$V^i(a^*, 0) = V^i(\bar{a}, \bar{z}^i) \quad \forall i \in \{1, \ldots, N\}.$$ 

**Proof.** See Appendix B. \hfill \Box

Note that a consequence of Theorem 1 is that egalitarian equivalent allocations satisfy individual rationality. The egalitarian equivalent level of assets must be nonnegative, so any egalitarian equivalent allocation at least weakly dominates the zero allocation which is
the relevant one for assessing individual rationality.

\[ V^i(a_M, z^i_m) \geq V^i(0, 0) \quad \forall i \in \{1, \ldots, N\}. \]

**Theorem 2.** An egalitarian equivalent allocation is Pareto efficient.

**Proof.** See Appendix C.

**Theorem 3.** An egalitarian equivalent mechanism is cost monotonic.

**Proof.** See Appendix D.

### 3.3 Numerical Examples

We now consider a simple example of an insurer with two representative consumers: consumer 1 and consumer 2, both with exponential utility with coefficients of absolute risk aversion equal to unity have initial wealth of 4.0 and 5.0, respectively. Both face binary loss distributions of total loss of their initial wealth (i.e., \( w^1 = L^1 = 4.0 \) and \( w^2 = L^2 = 5.0 \)) with the probability of 10%. Finally, suppose that the losses are independently distributed so that the maximum aggregate loss is 9.0 with the probability of 1%. Claim payments are calculated by pro rata shares in the case that the aggregate loss amount exceeds assets as defined in (14).

We can then express the expected utility functions for consumer \( i \) (\( i = 1, 2 \)) as:

\[
V^i = -0.1 \times 0.9 \times \exp\{-[w^i - L^i + \min(L^i, a) - p^i]\} \\
-0.1 \times 0.1 \times \exp\{-[w^i - L^i + \min(L^i, (a/(4 + 5))L^i) - p^i]\} \\
-0.9 \times \exp\{-(w^i - p^i)]
\]

where \( p^i \) is the premium paid by consumer \( i \) and \( a \) is the asset level of the company. We
assume that the cost of holding assets is a linear function of the assets held, as in

\[
c(a) = \begin{cases} 
\tau a & \text{if } a > 0 \\
0 & \text{otherwise}
\end{cases}
\]

where \( \tau \) represents the cost per asset, so that premiums follow (15) with \( z^1 + z^2 = \tau a \).

We can then specify the Pareto problem as:

\[
\max_{a, z^1, z^2} V^1 + \lambda V^2
\]

subject to \( z^1 + z^2 = \tau a \) with \( \lambda \) being the relative weight on the second consumer.

The Pareto-optimal level of assets in this case is independent of the Pareto weight. The optimal level of assets approaches the maximum loss 9.0 as \( \tau \) approaches to zero and monotonically decrease as \( \tau \) increases as shown Figure 9. For \( \tau < 0.055 \), the optimal level of assets is greater than 5.0, which is sufficient unless both losses happen simultaneously. For \( \tau > 0.191 \), the optimal level of assets is less than 4.0, which is insufficient to pay for any single loss. Thus, the potential losses of each consumer are the critical levels of assets in calculating tail-based asset cost allocations.

Figure 9 also shows that the EE level of asset is monotonically decreasing. Note that the EE level of assets is the level of assets such that the EE assets without any cost of holding asset makes agents indifferent from the optimal asset with asset cost allocation. That is, the allocation rule is determined by their willingness to pay for the increase of the level of asset from the EE level to the optimal level.

Figure 10 illustrates the asset cost allocation to the first consumer with \( w^1 = L^1 = 4.0 \), which can be justified by a particular weighting scheme (i.e., a particular level of \( \lambda \)). Specifically, we compare proposed egalitarian equivalent (EE) allocation method with two allocation methods: Tail Value-at-Risk (TVaR) and Lindahlian (Lindahl) allocations. TVaR is computed with a threshold corresponding to the point of default:

\[
E[L^1 + L^2 | L^1 + L^2 > a]
\]
A Lindahl solution (see Kaneko, 1977), on the other hand, would feature cost shares based on the value placed by each consumer on the marginal unit of company assets. In other words,

\[ z^i = -\left( \frac{\partial V}{\partial a} \right) \times a \]

Our problem of interest concerns the stability of the allocations, and this problem is clearly illustrated by the latter two approaches—allocation based on the gradient of TVaR allocation and Lindahl allocation around the critical levels of asset, 4.0 and 5.0. For instance, a small improvement of cost function by changing \( \tau \) from 19.2% to 19.1% corresponding
Table 3: Allocation of Asset Cost to Consumer 1

<table>
<thead>
<tr>
<th>tau</th>
<th>Optimal Assets</th>
<th>EE Assets</th>
<th>EE Allocation</th>
<th>TVaR Allocation</th>
<th>Lindahl Allocation</th>
</tr>
</thead>
<tbody>
<tr>
<td>0.020</td>
<td>6.803</td>
<td>4.307</td>
<td>0.299</td>
<td>0.444</td>
<td>0.359</td>
</tr>
<tr>
<td>0.040</td>
<td>5.767</td>
<td>3.679</td>
<td>0.229</td>
<td>0.444</td>
<td>0.342</td>
</tr>
<tr>
<td>0.060</td>
<td>4.958</td>
<td>3.344</td>
<td>0.217</td>
<td>0.074</td>
<td>0.353</td>
</tr>
<tr>
<td>0.080</td>
<td>4.778</td>
<td>3.109</td>
<td>0.227</td>
<td>0.074</td>
<td>0.289</td>
</tr>
<tr>
<td>0.100</td>
<td>4.616</td>
<td>2.917</td>
<td>0.239</td>
<td>0.074</td>
<td>0.251</td>
</tr>
<tr>
<td>0.120</td>
<td>4.468</td>
<td>2.754</td>
<td>0.251</td>
<td>0.074</td>
<td>0.224</td>
</tr>
<tr>
<td>0.140</td>
<td>4.330</td>
<td>2.611</td>
<td>0.263</td>
<td>0.074</td>
<td>0.205</td>
</tr>
<tr>
<td>0.160</td>
<td>4.201</td>
<td>2.483</td>
<td>0.273</td>
<td>0.074</td>
<td>0.191</td>
</tr>
<tr>
<td>0.180</td>
<td>4.080</td>
<td>2.367</td>
<td>0.284</td>
<td>0.074</td>
<td>0.179</td>
</tr>
<tr>
<td>0.200</td>
<td>3.947</td>
<td>2.262</td>
<td>0.294</td>
<td>0.444</td>
<td>0.155</td>
</tr>
</tbody>
</table>

Due to the instability of the allocations, the increase in assets will not necessarily be welcomed by both consumers under the TVaR gradient allocations. For the cost improvement from 5.6% to 5.5% associated with an increase in asset from 4.99 to 5.23, the first consumer’s utility drops from -0.0288 to -0.0319, while the second consumer’s utility gains from -0.0152 to -0.0137. This illustrates that an allocation mechanism which assigns cost allocations based on the TVaR gradient fails cost monotonicity: Even though the transition from $c(a)$ to $\hat{c}(a)$ involves a cost improvement, the first consumer ends up getting worse off because of the reallocation of frictional cost.

A similar characterization holds for Lindahl mechanism. The Lindahl solution is less dramatic but still shows small discontinuous changes around the critical assets. Specifically, for cost improvement around the level of asset 4.0, the cost allocation to the first consumer discontinuously increases because its marginal rate of substitution goes up for the marginal asset which is not associated with major improvement of its loss recovery. For the cost improvement around the critical level of asset 4.0 by changing $\tau$ from 19.2% to 19.1%, the
first consumer gets worse off with its declining utility from -0.0326 to -0.0330. For the same reason, the cost allocation to the second consumer slightly jumps up when the cost improves around the critical level of asset 5.0.

The associated EE cost allocation features stable allocation rules between consumers. The allocation to the first consumer declines as the cost function improves and starts increasing only when the asset exceeds 5.0. In contrast to the results observed under the TVaR and Lindahl mechanisms, an EE mechanism guarantees that both consumers will welcome the improved cost structure.

### 3.3.1 Cost Allocation with Correlated Losses

Here we relax the assumption of independent losses by incorporating correlation of loss occurrence. This change affects both the optimal level of asset and cost allocation. Particularly, negatively correlated loss occurrence leads a smaller Pareto optimal asset and a larger swing of cost allocation due to a smaller probability of simultaneous losses (Figure 11). Similarly, positively correlated loss occurrence is associated with a larger size of asset and a smaller change of cost allocation because simultaneous losses are more likely to happen (Figure 12). Although the fluctuation of TVaR allocation rules becomes smaller for the positively correlated losses, large jumps remains. The share of the first consumer under the TVaR allocation becomes completely flat within a reasonable range of the asset cost if the correlation is sufficiently large. The Lindalh allocation rule also becomes stable and approaches the EE allocation for highly correlated losses.

### 3.3.2 Cost Allocation with More Consumers

Increase in the number of consumers generally reduces the instability of cost allocation unless correlation of loss occurrence is not high. For instance, assuming independent 100 consumers in total with 50 consumers for each consumer type, we can summarize the total share of costs for the first consumers as shown in Figure 13. The TVaR allocation rules become quite stable, yet instability with respect to cost improvement still remains. For instance, when capital cost improves from 8.8% to 8.7%, the total share of the first consumer type is increased by 1.4%. In contrast, both the EE allocation rule and the Lindalh alloca-
Figure 11: Allocation Rule for Negatively Correlated (-0.1) Losses

Figure 12: Allocation Rule for Positively Correlated (0.2) Losses
tion rules are stable over optimal assets and range within only 0.4%. This also illustrates the stability of the EE cost allocation with respect to asset cost.

![Graph showing allocation rule for 100 Consumers](image)

**Figure 13: Allocation Rule for 100 Consumers**

### 3.3.3 CRRA Utility Specification

The stability of the EE cost allocation does not depend on the choice of utility function. Here we reproduce the cost allocation rule based on CRRA utility function, specifically log utility function, log(w). The allocation rule for the CRRA utility shown in Figure 14 appears quite different from the CARA utility specification (Figure 10) but both are consistent in that the allocation rules observed in the entire range of asset cost in Figure 10 are similar to those observed from 0 to 3% in Figure 14.

### 3.4 Catastrophe Insurance Claims

We now apply the allocation methods to catastrophe insurance claims data. The data contains 5000 loss realizations for 4 types of risk: Earthquake, Wind, Crop/Brushfire, and Terror/Casualty. The summary statistics of the claim data is reported in Table 4. As observed, wind risk tends to have large claims and has a long right tail. Earthquake losses also have a long right tail relative to other two types with the maximum loss of 771 million. Thus, the loss distributions of risks are heterogeneous.
Figure 14: Cost Allocation Rule for 2 Consumers with Log Utility

Table 4: Summary Statistics of Insurance Claims (USD; Millions)

<table>
<thead>
<tr>
<th>Coverage</th>
<th>Mean</th>
<th>SD</th>
<th>Median</th>
<th>75th pctl</th>
<th>90th pctl</th>
<th>95th pctl</th>
<th>99th pctl</th>
<th>Max</th>
</tr>
</thead>
<tbody>
<tr>
<td>Earthquake</td>
<td>22.84</td>
<td>53.93</td>
<td>9.79</td>
<td>11.52</td>
<td>29.79</td>
<td>78.67</td>
<td>306.99</td>
<td>771.29</td>
</tr>
<tr>
<td>Wind</td>
<td>138.31</td>
<td>147.95</td>
<td>81.58</td>
<td>139.52</td>
<td>295.68</td>
<td>457.00</td>
<td>786.67</td>
<td>1377.16</td>
</tr>
<tr>
<td>Crop/Brushfire</td>
<td>18.72</td>
<td>28.71</td>
<td>10.18</td>
<td>18.06</td>
<td>28.28</td>
<td>62.38</td>
<td>166.33</td>
<td>347.54</td>
</tr>
<tr>
<td>Terror/Casualty</td>
<td>10.75</td>
<td>15.77</td>
<td>5.76</td>
<td>8.69</td>
<td>19.90</td>
<td>40.21</td>
<td>100.96</td>
<td>158.63</td>
</tr>
<tr>
<td>Total</td>
<td>190.62</td>
<td>164.47</td>
<td>127.23</td>
<td>210.22</td>
<td>387.31</td>
<td>543.32</td>
<td>892.13</td>
<td>1588.23</td>
</tr>
</tbody>
</table>
To compute the capital allocations, we make several assumptions. First, we assume a representative agent for each risk so that the Pareto optimal level of asset and the capital allocations are identified by the four representative agents’ expected utilities for 5000 loss realizations. To be consistent with previous numerical examples, agents have an exponential utility with the risk averse coefficient one. Their initial wealth are set to be the same as their maximum loss (i.e., $W^i = L^i$ for $i = 1, 2, 3, 4$). As before, premiums are calculated by the expected recovery of loss plus cost of holding asset.

The Pareto optimal level of asset is 1025 million at $\tau = 0.1\%$, which is approximately 99.6 percentile of the aggregate loss distribution but not close to the maximum aggregate loss of 1,588 million because the small cost of asset results in heavy cross-subsidies between risks – earthquake risk and wind risk subsidize their wealth to other small risks at optimal. Again, under the CARA utility function, the Pareto optimal level of asset is independent of the choice of Pareto weights and the allocation methods are justified by changing the Pareto weights. The asset cost allocation under the EE allocation and the TVaR allocation are summarized in Figures 15-16 and Table 5. The identified allocation rules can be explained by the large difference in the size of losses between risks. Comparing the size of the EE level of assets reported in Table 5 with loss distributions of risks in Table 4, we confirm that expanding the size of assets from the EE asset to the optimal assets mostly benefits the wind risk.

Therefore, the EE allocation method imposes the wind risk to be largely responsible for the cost of holding asset when the size of asset is large but the share gradually declines when the asset size becomes smaller. This contribution rule contrasts with the commonly used approach focusing on the tail of loss distribution. We observe that TVaR allocation fluctuates especially where the size of asset is large. For instance, when cost improves from 0.15% to 0.1%, the cost share for wind risk increases by 4%, which causes utility loss for wind risk. In contrast, the EE allocation exhibit stability which guarantees cost monotonicity.

3.5 Concluding Remarks

This paper explored egalitarian equivalence as a capital allocation concept, and argued that it is suitable for situations where the level of capital is variable but the risk portfolio
Figure 15: EE Cost Allocation Rule for 5000 Cat sample

Figure 16: TVaR Cost Allocation Rule for 5000 Cat sample

Table 5: Asset Cost Allocation for Catastrophe Insurance Claims

<table>
<thead>
<tr>
<th>tau</th>
<th>Optimal Assets</th>
<th>EE Assets</th>
<th>EE Share</th>
<th>TVaR Share</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td></td>
<td></td>
<td>EQ</td>
<td>Wind</td>
</tr>
<tr>
<td>0.005</td>
<td>666.6</td>
<td>366.8</td>
<td>0.059</td>
<td>0.930</td>
</tr>
<tr>
<td>0.010</td>
<td>525.7</td>
<td>250.8</td>
<td>0.074</td>
<td>0.910</td>
</tr>
<tr>
<td>0.015</td>
<td>435.8</td>
<td>182.7</td>
<td>0.085</td>
<td>0.895</td>
</tr>
<tr>
<td>0.020</td>
<td>367.2</td>
<td>132.9</td>
<td>0.094</td>
<td>0.880</td>
</tr>
<tr>
<td>0.025</td>
<td>311.3</td>
<td>87.3</td>
<td>0.106</td>
<td>0.860</td>
</tr>
<tr>
<td>0.030</td>
<td>262.8</td>
<td>22.1</td>
<td>0.137</td>
<td>0.812</td>
</tr>
</tbody>
</table>
is fixed. In such circumstances, the capital cost allocation problem is isomorphic with the much-studied economic problem of how to share the cost of a public good. The egalitarian equivalent allocation approach has the significant advantage of cost monotonicity, which delivers stability.

However, it must be stressed that this advantage is context-dependent: Egalitarian equivalent allocation methods are not appropriate for pricing applications where the risk portfolio is not fixed. When the problem is one of portfolio optimization, marginal cost pricing dictates the use of allocation methods, such as the Euler method in the case of risk-measure constrained portfolio optimization, even if the method produces unstable allocations. Indeed, the Euler method is likely to yield unstable allocations unless one is willing to select the risk measure specifically for stability properties.

Moulin showed that egalitarian equivalent mechanisms are the only ones that can be guaranteed to be cost monotonic in all situations, but it is possible that other methods might be admissible if further restrictions are added to nature of the cost functions. Additional restrictions might be worth exploring because the egalitarian equivalent mechanism may not be intuitive for everyone. Moulin’s terminology was evidently intended to parallel egalitarian equivalence for private good allocations (Pazner and Schmeidler, 1978). There are similarities in process: Egalitarian equivalent cost shares are found by calculating amounts that yield a particular utility distribution, while egalitarian equivalent private good allocations are found by identifying Pareto optimal allocations that match a particular utility distribution. However, the relevance of the reference point in the private case (the utility distribution associated with an economy in which all goods are shared equally) is easily and intuitively grasped, while the relevance of the corresponding reference point for the public case is less obvious. Future research may uncover other cost monotonic mechanisms in the context of more restricted settings.
A Dynamic Capital Allocation with Multiple Opportunities

Suppose the financial institution receives $n + 1$ opportunities in sequence from period 0 to period $n$. Upon receipt of the period-zero opportunity, it must decide on the quantity $q_0$ to invest in this known opportunity. Subsequent to this choice, $n$ opportunities will arrive. The risk characteristics of the subsequent opportunities are uncertain, but the possible characteristics, as well as the probabilities associated with their appearance, are known to the decision maker. For the $i$th opportunity, uncertainty about the risk characteristics is resolved upon receipt of the $i$th opportunity, at which point the institution decides on the quantity $q_i$ to invest in that opportunity. We denote the pool of possibilities for the $i$th opportunity as the set $\Omega_i$, and denote the uncertainty in the $i$th period by a random variable $\alpha_i$. The random variable representing all possible states of the world, covering all possible opportunities, is denoted $\alpha = \{\alpha_1, \cdots, \alpha_n\}$.

As in the two-opportunity case, the cost of risk is determined by risk capital:

$$\rho(q_0, q_1(\alpha^1), \ldots, q_n(\alpha^n); \alpha),$$

with the frictional cost of risk capital being $\tau \rho(q_0, q_1(\alpha^1), \ldots, q_n(\alpha^n); \alpha)$. In every future state of the world, the measured risk of the firm’s portfolio must not exceed a maximum level $K$. The complete set of possible realizations for $\alpha$ is represented by the set $\Omega^\alpha = \Omega_1 \times \Omega_2 \times \cdots \times \Omega_n$. The probability of any particular realization $\alpha \in \Omega^\alpha$ is given by $p(\alpha)$.

If we consider decisionmaking at the time of the period-zero opportunity, the optimization problem is to find the optimal quantity for the period-zero investment and a set of plans—contingent on different states of the world—for all subsequent $n$ opportunities. Moreover, the quantity chosen for the $i$th opportunity must be adapted to the information available at the arrival of the $i$th opportunity, since the $i$th decision only depends on the realized opportunity in that period along with the realizations of previous periods and the decisions made up to that point. Denote the random variable reflecting possible state of the world at the arrival of the $i$th opportunity to be $\alpha^i = \{\alpha_1, \alpha_2, \cdots, \alpha_i\}$, which takes values in the set $\Omega^i = \Omega_1 \times \Omega_2 \times \cdots \times \Omega_i$, each realization having the corresponding probability.
Thus, the $i$th decision $q_i$ must be a contingency plan for all possible realizations of the random variable $\alpha^i$. Therefore, the choice variables at the decision time on the current opportunity are $\{q_0, q_i(\alpha^i), \forall i \in [1, \ldots, n], \forall \alpha^i \in \Omega^i\}$. Thus, we can write the optimization problem as:

$$\max_{q_0, \{q_i(\alpha^i), \forall i \in [1, \ldots, n], \forall \alpha^i \in \Omega^i\}} q_0 \left\{ \mathbb{E}[r_0] + \sum_{i=1}^{n} \left[ \sum_{\alpha^i \in \Omega^i} p_i(\alpha^i) q_i(\alpha^i) \mathbb{E}[r_i(\alpha^i)] \right] \right. $$

$$\left. - \tau \sum_{\alpha \in \Omega^n} p(\alpha) \rho(q_0, q_1(\alpha^1), \ldots, q_n(\alpha^n); \alpha) \right\}, \quad (17)$$

subject to a set of constraints that constrain risk for each possible realization of $\alpha$:

$$\rho(q_0, q_1(\alpha^1), \ldots, q_n(\alpha^n); \alpha) \leq K \quad \forall \alpha \in \Omega^n. \quad (18)$$

The first order conditions for the problem can be expressed as:

$$\mathbb{E}[r_0] - \sum_{\alpha \in \Omega} (\tau p(\alpha) + \lambda(\alpha)) \frac{\partial \rho(q_0, q_1(\alpha^1), \ldots, q_n(\alpha^n); \alpha)}{\partial q_0} = 0, \quad (19)$$

$$p_j(\alpha^j) \mathbb{E}[r_j(\alpha^j)] - \sum_{\alpha \in \Omega^{-\alpha^j}} (\tau p(\alpha) + \lambda(\alpha)) \frac{\partial \rho(q_0, q_1(\alpha^1), \ldots, q_n(\alpha^n); \alpha)}{\partial q_j(\alpha^j)} = 0 \quad (20)$$

$\forall \alpha^j \in \Omega^j, 1 \leq j \leq n$ where $\lambda(\alpha)$ is the Lagrange multiplier associated with constraint (18) for the particular state $\alpha$, and $\Omega^{-\alpha^j}$ denotes the set of all possible states conditional on the first $j$ opportunities having been realized, in other words:

$$\Omega^{-\alpha^j} = \{\tilde{\alpha} | \tilde{\alpha}_1 = \alpha_1, \ldots, \tilde{\alpha}_j = \alpha_j, \tilde{\alpha}_{j+1} \in \Omega_{j+1}, \ldots, \tilde{\alpha}_n \in \Omega_n\}.$$

In particular, we obtain the first order condition for the last opportunity, when $j = n$, as follows:

$$p(\alpha) \mathbb{E}[r_n(\alpha)] - (\tau p(\alpha) + \lambda(\alpha)) \frac{\partial \rho(q_0, q_1(\alpha^1), \ldots, q_n(\alpha^n); \alpha)}{\partial q_n(\alpha)} = 0 \quad \forall \alpha \in \Omega^n.$$

Equation (19) balances the marginal benefit of exposure to the zero-period risk (the expected return) with its marginal cost, which is a risk cost relating to the risk measure.
constraint, while equation (20) does the same for the other risks in each of the possible states of the world given the previous path of realizations before the \( j \)th opportunity. Note in each state that \( \lambda(\alpha) \) reflects the shadow price or marginal value of state-contingent risk capital (i.e., at time zero, what an additional dollar of risk capital in state \( \alpha \)—and only in state \( \alpha \)—would be worth to the firm, net of its associated frictional cost \( \tau \)). If we assume that condition (20) always holds in the last period, we can write:

\[
\lambda(\alpha) = p(\alpha) \frac{\mathbb{E}[r_n(\alpha)]}{\partial \rho(q_0, q_1(\alpha^1), \ldots, q_n(\alpha^n); \alpha)} - \tau \left( \frac{\partial_p(q_0, q_1(\alpha^1), \ldots, q_n(\alpha^n); \alpha)}{\partial q_n(\alpha)} \right) \forall \alpha \in \Omega^n. \tag{21}
\]

Thus, the marginal cost of risk in each final state is equal to the marginal amount of risk capital consumed by the exposure (calculated as the partial derivative of the risk measure with respect to the quantity of the risk) times the value of that risk capital. In the case of exposures before the last opportunity, the marginal cost of risk at the time of their selection is an expected marginal cost, since both the amount and the value of the risk capital that the exposure will ultimately consume depends on the course of future opportunity realizations, as revealed in equation (19). To elaborate, we can use (20) and (21) to obtain:

\[
\mathbb{E}[r_j(\alpha^j)] = \mathbb{E} \left[ \left( \tau + \frac{\mathbb{E}[r_n(\alpha)]}{\partial \rho(q_0, q_1(\alpha^1), \ldots, q_n(\alpha^n); \alpha)} \right) \frac{\partial \rho}{\partial q_j(\alpha^j)} \right] \forall \alpha \in \Omega^{-\alpha^j}. \tag{22}
\]

If the risk measure \( \rho \) is homogeneous, we get

\[
\frac{\partial \rho(q_0, q_1(\alpha^1), \ldots, q_n(\alpha^n); \alpha)}{\partial q_i(\alpha^i)} = \rho(q_0, q_1(\alpha^1), \ldots, q_n(\alpha^n); \alpha) \quad \forall \alpha \in \Omega^n, \tag{23}
\]

and, thus, we have:

\[
\sum_{\alpha \in \Omega^n} (\tau \rho(\alpha) + \lambda(\alpha)) \left[ \frac{\partial \rho(q_0, q_1(\alpha^1), \ldots, q_n(\alpha^n); \alpha)}{\partial q_0} + \sum_{i=1}^{n} \frac{\partial \rho(q_0, q_1(\alpha^1), \ldots, q_n(\alpha^n); \alpha)}{\partial q_i(\alpha^i)} q_i(\alpha^i) \right] = \sum_{\alpha \in \Omega^n} (\tau \rho(\alpha) + \lambda(\alpha)) \rho(q_0, q_1(\alpha^1), \ldots, q_n(\alpha^n); \alpha) = \tau p + \sum_{\alpha \in \Omega^n} \lambda(\alpha) K.
\]

Therefore, marginal cost has a risk capital allocation interpretation that “adds up” in the multiple opportunity case as well in a form similar to the two-period case. As before,
if the total risk constraint never binds, then the sum of marginal costs times exposures contemplated reduces to $\tau \bar{\rho}$. In this case, total capacity $K$ is never fully utilized, but the average risk $\bar{\rho}$ is again fully allocated to each exposure through marginal cost pricing, with each unit of allocated risk being charged the frictional cost $\tau$. On the other hand, if the total risk constraint always binds, then total risk costs tally up to $(\tau + \sum_{\alpha \in \Omega^n} \lambda(\alpha)) K$. which is again interpreted as a cost of capital (in parentheses) times total capital. In intermediate cases, the risk cost that is allocated is again the total risk capital times the frictional cost, $\tau \rho$, plus the total shadow costs of risk capital, $\sum_{\alpha \in \Omega^n} \lambda(\alpha) K$.

If we consider the capital cost allocation to the $j$th risk, we have:

$$\sum_{\alpha \in \Omega^n} p_n(\alpha) \left[ \tau + \frac{\mathbb{E}[r_n(\alpha)] - \tau \frac{\partial \rho(q_0, q_1(\alpha^1), \ldots, q_n(\alpha^n); \alpha)}{\partial q_n(\alpha)}}{\partial q_n(\alpha)} \right] \left[ \frac{\partial \rho(q_0, q_1(\alpha^1), \ldots, q_n(\alpha^n); \alpha)}{\partial q_j(\alpha^j)} q_j(\alpha^j) \right].$$

For each final state of the world, we multiply the probability of the state $\alpha$ times the marginal value of capital in state $\alpha$ times the capital allocated to the $j$th risk in state $\alpha$; the total cost allocation is then the sum of these figures over all states in $\Omega^n$. Moreover, the capital allocation can be rewritten as follows:

$$\sum_{\alpha^j \in \Omega^j} \left\{ p_j(\alpha^j) \left[ \sum_{\alpha \in \Omega^{n-j}} \Pr(\alpha|\alpha^j) \left[ \tau + \frac{\mathbb{E}[r_n(\alpha)] - \tau \frac{\partial \rho}{\partial q_n(\alpha)}}{\partial q_n(\alpha)} \right] \frac{\partial \rho}{\partial q_j(\alpha^j)} q_j(\alpha^j) \right] \right\}.$$  

Given a particular path until the period $j$, we multiply the conditional probability of the remaining possible states times the marginal value of capital in the state times the capital allocation to the $j$th risk in the state. The total cost allocation for the particular path $\alpha^j$ is the sum of all the figures over all sub-states. The sum of all the resulting path-contingent capital allocations times the probabilities of the path is the total cost allocation.

In particular, the capital allocation to the period-zero risk can be expressed as:

$$\sum_{\alpha \in \Omega^n} p(\alpha) \left[ \tau + \frac{\mathbb{E}[r_n(\alpha)] - \tau \frac{\partial \rho}{\partial q_n(\alpha)}}{\partial q_n(\alpha)} \right] \frac{\partial \rho}{\partial q_0} q_0.$$  

As in the two opportunity case, we can recover a RORAC result:
\[ \frac{\mathbb{E}[r_0]}{\sum_{\alpha \in \Omega^n} p(\alpha) \frac{\partial \rho}{\partial q_0}} = \frac{\sum_{\alpha \in \Omega^n} p(\alpha) \left[ \tau + \mathbb{E}[r_n(\alpha)] - \tau \frac{\partial \rho}{\partial q_n(\alpha)} \right] \left[ \frac{\partial \rho}{\partial q_0} \right]}{\sum_{\alpha \in \Omega^n} p(\alpha) \frac{\partial \rho}{\partial q_0}}, \]

where the right-hand side reflects the expectation of the marginal value of risk capital. As before, this will in general be larger than the carrying cost of risk capital \( \tau \), depending on the extent to which the risk constraints bind at the optimum.

B Proof of Theorem 1 (Moulin, 1987)

Prove finiteness of \( a^* \): Risk aversion and non-trivial loss distributions implies that

\[ V^i(a, 0) > V^i(0, 0) \quad \forall i \in \{1, \ldots, N\}, a > 0. \]

We take an increasing sequence \( \hat{a}_t \) such that

\[ \lim_{t \to \infty} \hat{a}_t = a^*. \quad (25) \]

By way of contradiction, suppose

\[ \lim_{t \to \infty} \hat{a}_t = a^* = \infty. \quad (26) \]

By definition of \( a^* \), we know there is an associated sequence of feasible allocations \( (a_t, z^1_t, \ldots, z^N_t) \) satisfying:

\[ V^i(\hat{a}_t, 0) \leq V^i(\hat{a}_t, z^i_t) \quad \forall i \in \{1, \ldots, N\}. \quad (27) \]

Suppose this sequence \( a_t \) is also unbounded. Then we can find a subsequence, denoted \( \check{a}_t \), that converges to infinity.

Denote the upper bounds of the loss distributions by \( \bar{L}_i \). An intermediate value argument, which we can apply due to the observation that \( V^i(a_t, 0) \geq V^i(0, 0) \geq V^i(a_t, \bar{L}_i) \forall i \), and the continuity of the utility functions, imply that for each \( i \) there exists a function \( z_i(.) \) satisfying:

\[ V^i(\check{a}_t, z^i_t) \geq V^i(\check{a}_t, 0) \geq V^i(0, 0) = V^i(\check{a}_t, z_i(\check{a}_t)) \quad \forall i, t. \quad (28) \]
Because the loss distributions are bounded, assets have no value beyond a certain point, so $z_i(.)$ is bounded from above, so (28) implies that $\dot{z}_i^t$ must be bounded from above as well.

It follows that

$$\limsup_{t \to \infty} \left\{ \frac{\dot{z}_i^t}{a_t} \right\} \leq 0 \quad \forall i \in 1, \ldots, N,$$

and moreover that

$$\limsup_{t \to \infty} \left\{ \sum_{i} \frac{\dot{z}_i^t}{a_t} \right\} \leq 0.
$$

However, notice that feasibility and the convexity of the cost function implies that:

$$\limsup_{t \to \infty} \left\{ \sum_{i} \frac{\dot{z}_i^t}{a_t} \right\} = \limsup_{t \to \infty} \left\{ \frac{c(a_t)}{a_t} \right\} > 0,$$

which contradicts the previous result. Thus the sequence $a_t$ must be bounded, meaning that

$$\lim_{t \to \infty} a_t = q < \infty$$

By assumption of unboundedness, $\hat{a}_t > q$ for large enough $t$, so (27) then implies that $z_i^t \leq 0$ for all $i \in \{1, \ldots, N\}$, which violates feasibility, a contradiction indicating that $a^* < \infty$.

**Prove $V^i(a^*, 0) = V^i(\bar{a}, \bar{z}^i) \quad \forall i \in \{1, \ldots, N\}$:**

First, we prove that a feasible allocation $(a, z^1, \ldots, z^N)$ satisfies

$$V^i(a^*, 0) \leq V^i(a, z^i) \quad \forall i \in 1, \ldots, N. \quad (29)$$

We take a bounded increasing sequence $\hat{a}_t$ such that

$$\lim_{t \to \infty} \hat{a}_t = a^* < \infty$$

associated sequence of feasible allocations $(a_t, z^1_t, \ldots, z^N_t)$ satisfying (27). We know from the previous step that all elements of this sequence are bounded, so the associated sequence
must have a convergent subsequence. Define \( \hat{\Omega} \subset \Omega \) as:

\[
\hat{\Omega} = \begin{cases} 
(a_t, z^1_t, \ldots, z^N_t) \mid Q \times \sum_i \bar{L}_i \geq a \geq 0, \sum_i z^i = c(a), 
\end{cases}
\]

where \( Q \) is any number greater than 1. Notice that \((a_t, z^1_t, \ldots, z^N_t) \in \hat{\Omega}\) for all \( t \), since \( \hat{a}_t \geq 0 \) and any feasible allocation lying outside \( \hat{\Omega} \) would involve a violation of (27). Moreover, since \( \hat{\Omega} \) is closed, any convergent subsequence of \((a_t, z^1_t, \ldots, z^N_t)\) converges to a limit point of \( \hat{\Omega} \), so (29) is satisfied.

Given \( a^* \geq 0 \), note that egalitarian equivalence implies that \( \bar{z}^i \notin \{-Q \times \max\{\bar{L}^1, \ldots, \bar{L}^N\}, Q \times \max\{\bar{L}^1, \ldots, \bar{L}^N\}\} \forall \in \{1, \ldots, N\} \). To see why, consider the case where \( \bar{z}^i = Q \times \max\{\bar{L}^1, \ldots, \bar{L}^N\} \) for some \( i \). Then it follows that:

\[
V^i(a^*, 0) \geq V^i(0, 0) \geq \mathbb{E}u^i(w^i - \bar{L}^i) > V^i(\bar{a}, \bar{z}^i)
\]

which is inconsistent with egalitarian equivalence. Now suppose that for some \( i \), \( \bar{z}^i = -Q \times \max\{\bar{L}^1, \ldots, \bar{L}^N\} \). Note that, since \( \bar{a} \geq 0 \), this implies there must be at least one \( j \neq i \) such that \( \bar{z}^j > \max\{\bar{L}^1, \ldots, \bar{L}^N\} \). But then

\[
V^j(a^*, 0) \geq V^j(0, 0) \geq \mathbb{E}u^j(w^j - \bar{L}^j) > V^j(\bar{a}, \bar{z}^j)
\]

which is inconsistent with egalitarian equivalence. Thus it follows that \( \bar{z}^i \) will always lie in the interior of \( \{-Q \times \max\{\bar{L}^1, \ldots, \bar{L}^N\}, Q \times \max\{\bar{L}^1, \ldots, \bar{L}^N\}\} \).

Moving on, by way of contradiction, suppose that \( V^i(a^*, 0) = V^i(\bar{a}, \bar{z}^i) \) is not satisfied for all \( i \). This implies that there exists some nonempty subset of consumers (which we will denote by \( M \)) such that:

\[
V^k(a^*, 0) < V^k(\bar{a}, \bar{z}^k) \quad \forall k \in M
\]

Note that \( M \) cannot be equivalent to \( \{1, \ldots, N\} \) (i.e., \( V^i(a^*, 0) = V^i(\bar{a}, \bar{z}^i) \) must hold for some \( i \)), as this would contradict the egalitarian equivalence of \( a^* \) since we could increase \( a^* \) by some amount if \( V^k(a^*, 0) < V^k(\bar{a}, \bar{z}^k) \) for all \( k \in \{1, \ldots, N\} \). So we consider a
complementary set \( L = \{1, \ldots, N\}/M \) with

\[
V^j(a^*, 0) = V^j(\bar{a}, \bar{z}^j) \quad \forall j \in L.
\]

But this is also incompatible with the egalitarian equivalence of \( a^* \) since, given that all cost shares are interior to the choice set, we could form a new feasible allocation, \((\bar{a}, \bar{z}^1, \ldots, \bar{z}^N)\), where \( \bar{a} = \bar{a} \) and we have subtracted some small amount from each of cost shares of all agents in \( L \) and divided the sum total of those deductions among the agents in \( M \) so that:

\[
V^k(a^*, 0) < V^k(\bar{a}, \bar{z}^k) \quad \forall k \in \{1, \ldots, N\}.
\]

This contradiction implies that \( V^j(a^*, 0) = V^j(\bar{a}, \bar{z}^j) \) must be satisfied for all \( i \in \{1, \ldots, N\} \).

C Proof of Theorem 2

Denote an egalitarian equivalent allocation as \((\hat{a}, \hat{z}^1, \ldots, \hat{z}^N)\) and the associated egalitarian equivalent level of public good production as \( a^* \). Suppose it is not Pareto efficient. Then there exists a feasible alternative allocation \((\bar{a}, \bar{z}^1, \ldots, \bar{z}^N)\) satisfying:

\[
V^i(a^*, 0) = V^i(\hat{a}, \hat{z}^i) \leq V^i(\bar{a}, \bar{z}^i) \quad \forall i \in \{1, \ldots, N\}
\]

with strict equality for at least one of the \( i \)'s. Let \( k \) index one of the agents for whom the inequality is strict. Then there exists some \( \varepsilon > 0 \) such that

\[
V^k(\hat{a}, \hat{z}^i) < V^k(\bar{a}, \bar{z}^k + \varepsilon) < V^i(\bar{a}, \bar{z}^k)
\]

Let

\[
\begin{align*}
\bar{z}^i & = \bar{z}^i - \frac{\varepsilon}{N - 1} \quad \forall i \neq k \\
\bar{z}^k & = \bar{z}^k + \varepsilon
\end{align*}
\]
Note that \((\hat{a}, \hat{z}^1, \ldots, \hat{z}^N) \in \Omega\). But since utility is strictly decreasing in the second argument

\[ V^i(a^*, 0) = V^i(\hat{a}, \hat{z}^i) < V^i(\bar{a}, \bar{z}^i) \quad \forall i \in \{1, \ldots, N\} \]

which is inconsistent with \(a^*\) being the egalitarian equivalent level of public good production.

\[ D \quad \text{Proof of Theorem 3} \]

Suppose not. Then there exist two cost functions \(c_1(.)\) and \(c_2(.)\), with \(c_1 \leq c_2\), but where the associated egalitarian equivalent levels of assets, \(a_1^*\) and \(a_2^*\), satisfy \(a_1^* < a_2^*\). Let \((a_2, z_2^1, \ldots, z_2^N)\) be an egalitarian equivalent allocation assigned by the mechanism under \(c_2(.)\) and \((a_1, z_1^1, \ldots, z_1^N)\) an egalitarian equivalent allocation assigned under \(c_1(.)\). Note that:

\[
\left( a_2, z_2^1 - \frac{c_2(a_2) - c_1(a_2)}{N}, \ldots, z_2^N - \frac{c_2(a_2) - c_1(a_2)}{N} \right)
\]

is a feasible allocation under \(c_1(.)\). Egalitarian equivalence, together with \(c_1 \leq c_2\), implies that

\[ V^i(a_2^*, 0) = V^i(a_2, z_2^i) \leq V^i \left( a_2, z_2^i - \frac{c_2(a_2) - c_1(a_2)}{N} \right) \quad \forall i \in \{1, \ldots, N\}. \]

But egalitarian equivalence, together with \(a_1^* < a_2^*\), implies that

\[ V^i(a_2^*, 0) > V^i(a_1^*, 0) = V^i(a_1, z_1^i) \quad \forall i \in \{1, \ldots, N\}. \]

Putting these together yields

\[ V^i(a_1, z_1^i) = V^i(a_1^*, 0) < V^i \left( a_2, z_2^i - \frac{c_2(a_2) - c_1(a_2)}{N} \right) \quad \forall i \in \{1, \ldots, N\}. \]

which contradicts the supposition that \(a_1^*\) is egalitarian equivalent under \(c_1(.)\).

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