

Capital Requirements, Acceptable Risks and Profits

Date: 11-12-2009

Start Time: 5:30pm

End Time: 7:00pm

Speaker: Dilip B. Madan, Robert H. Smith School of Business

Location: Park Avenue Plaza at 55 East 52nd Street 11th Floor

ABSTRACT

The optimality of free markets is called into question by the presence of limited liability. Risk distortions induced by limited liability in the private sector are documented. It is noted that risk preferences are biased towards higher volatility, skewness and kurtosis coupled with an incentive to decorrelate assets from liabilities. The consequence is economically poor risk choices that are exaggerated by compensation aligned with stock market values. In such a context we introduce the concept of socially acceptable risks, operationalized by a positive expectation after distortion of the distribution function for risky cash flows. This results in a definition of capital requirements making the risks undertaken acceptable to the wider community. Enforcing such capital requirements can mitigate the perverse risk incentives introduced by limited liability provided that the set of acceptable risks is suitably conservatively defined. A careful, critical and external assessment of capital requirements is therefore essential for the efficient and proper functioning of the private sector.

BIO

Dilip Madan is Professor of Finance at the Robert H. Smith School of Business. He specializes in Mathematical Finance. Currently he serves as a consultant to Morgan Stanley, and Caspian Capital LLC. He has also consulted with Citigroup, Bloomberg, the FDIC and Wachovia Securities. He is a founding member and Past President of the Bachelier Finance Society.

He received the 2006 von Humboldt award in applied mathematics, and was the 2007 Risk Magazine Quant of the Year. He is the Managing Editor of Mathematical Finance, Co-editor of the Review of Derivatives Research, and Associate Editor for the Journal of Credit Risk, and Quantitative Finance.

Recent major contributions have appeared in Mathematical Finance, Finance and Stochastics, Quantitative Finance, The Journal of Computational Finance, among other Journals.