20 One-Liners to Remember

Quick-fire facts for last-minute revision.

1. **RAROC stands for Risk-Adjusted Return on Capital.**
RAROC ties credit, market and operational risk into one comparable risk-adjusted return figure used across the IIBF risk syllabus.

2. **RAROC was pioneered at Bankers Trust in the late 1970s.**
The framework originated at Bankers Trust and is now embedded in most large banks' internal capital adequacy process.

3. **RAROC = (Expected Revenue - Operating Costs - Expected Loss + Return on Economic Capital) / Economic Capital.**
This is the standard RAROC formula IIBF candidates must memorise and apply in numerical questions.

4. **Expected Loss (EL) is calculated as PD multiplied by LGD multiplied by EAD.**
PD is probability of default, LGD is loss given default, and EAD is exposure at default.

5. **Expected Loss is subtracted from revenue in the RAROC numerator rather than being capitalised.**
EL is treated as a routine cost of doing business, unlike unexpected loss which needs capital backing.

6 **Economic Capital (EC) is held against unexpected loss, not expected loss.**
EC is the RAROC denominator that makes the ratio risk-adjusted rather than a plain profitability measure.

7 **Economic Capital is approximately Value at Risk minus Expected Loss.**
This VaR-based measure captures the unexpected loss at a chosen confidence level over a one-year horizon.

8 **Economic capital captures diversification, since risks that do not move together need less combined capital.**
Uncorrelated exposures require less capital together than the simple sum of their individual capital needs.

9 **Economic capital spans credit, market and operational risk in one consistent measure.**
This lets a bank compare very different business lines on the same risk-adjusted basis.

10 **Regulatory capital is the Basel-based minimum a bank must hold, supervised in India by the RBI.**
Regulatory capital is a floor, while economic capital is the bank's own, often more granular, internal estimate.

11 **Economic capital is a bank's internal estimate of capital needed to stay solvent at a chosen confidence level.**
A 99.9 percent confidence target means holding enough capital to survive all but a 1-in-1000-year loss event.

12 **The hurdle rate used in RAROC decisions equals the bank's cost of equity capital.**
It represents the minimum return shareholders require for the risk they bear on their capital.

13 **If RAROC exceeds the hurdle rate, the exposure creates shareholder value and is accepted.**
This is the core RAROC accept-reject decision rule that is heavily tested in IIBF exams.

14 **If RAROC is below the hurdle rate, the exposure destroys value and should be rejected or re-priced.**
Options include raising the spread, cutting the exposure limit, or demanding more collateral to lower LGD.

15 **RAROC can be run in reverse to set a loan's interest rate so it clears a target hurdle rate.**
This converts an abstract risk appetite statement into a concrete, borrower-specific price.

16 **In RORAC, only the capital in the denominator is risk-adjusted, while the return in the numerator is not.**
RORAC differs from RAROC by risk-adjusting capital instead of adjusting the return itself.

17 **RARORAC risk-adjusts both the return in the numerator and the capital in the denominator.**
RAROC, RORAC and RARORAC are closely related risk-adjusted performance measures often confused in IIBF papers.

18 **RAROC supports capital allocation, performance measurement, limit setting and portfolio exit decisions.**
Scarce capital is steered toward business lines that deliver the highest risk-adjusted returns.

19 **Return on Equity (ROE) uses accounting equity and profit, treating all capital as equally risky.**
Unlike RAROC, ROE does not distinguish riskier exposures from safer ones when charging for capital.

20 **RAROC is embedded in the Internal Capital Adequacy Assessment Process (ICAAP) of most large banks.**
ICAAP is where banks translate risk-adjusted measures like RAROC into overall capital planning.