20 True or False

Decide, then check the answer and reason below each statement.

Question 1

RAROC stands for Risk-Adjusted Return on Capital.

TRUE

RAROC is the standard IIBF term for this risk-adjusted performance and capital measure.

Question 2

The RAROC framework was pioneered by JPMorgan in the 1990s.

FALSE

RAROC was pioneered at Bankers Trust in the late 1970s, not by JPMorgan in the 1990s.

Question 3

Expected Loss equals PD multiplied by LGD multiplied by EAD.

TRUE

This is the standard formula for expected loss using probability of default, loss given default and exposure at default.

Question 4

Expected Loss is added into Economic Capital rather than subtracted in the RAROC numerator.

FALSE

Expected Loss is subtracted from revenue in the numerator; only unexpected loss is covered by economic capital.

Question 5

Economic Capital is intended to cover unexpected loss, not expected loss.

TRUE

Expected loss is priced into revenue as a cost, while economic capital is the buffer against unexpected loss volatility.

Question 6

Economic capital and regulatory capital are always exactly the same amount for a bank.

FALSE

Regulatory capital is a Basel-based floor, while economic capital is the bank's own, often more granular, internal estimate.

Question 7

Regulatory capital is set under Basel rules and supervised in India by the Reserve Bank of India.

TRUE

The RBI supervises Basel-based regulatory capital requirements for Indian banks.

Question 8

The hurdle rate used to judge a RAROC result equals the bank's cost of equity capital.

TRUE

The hurdle rate is the minimum return shareholders require for the risk they bear.

Question 9

A loan is accepted under the RAROC rule whenever its RAROC is lower than the hurdle rate.

FALSE

A loan is accepted when RAROC exceeds the hurdle rate; a lower RAROC means the deal should be rejected or re-priced.

Question 10

In RORAC, the capital in the denominator is risk-adjusted but the return in the numerator is not.

TRUE

RORAC risk-adjusts only capital, unlike RAROC which risk-adjusts the return, and RARORAC which adjusts both.

Question 11

RARORAC risk-adjusts only the numerator and leaves the capital in the denominator unadjusted.

FALSE

RARORAC risk-adjusts both the return in the numerator and the capital in the denominator.

Question 12

Economic capital calculations account for diversification benefits across a portfolio.

TRUE

Risks that do not move together require less combined capital than the sum of their individual capital needs.

Question 13

The RAROC framework applies only to credit risk and cannot be used for market or operational risk.

FALSE

RAROC spans credit, market and operational risk, since economic capital can be measured for all three.

Question 14

A loan can show an accounting profit yet still fail the RAROC test against the hurdle rate.

TRUE

A loan can be margin-positive yet destroy value once charged for the economic capital needed to absorb potential losses.

Question 15

Return on Equity is more risk-sensitive than RAROC because it uses economic capital in its denominator.

FALSE

ROE uses accounting equity, not economic capital, and treats all capital as equally risky unlike RAROC.

Question 16

RAROC can be run in reverse to determine the loan spread needed to meet a target hurdle rate.

TRUE

Solving the RAROC formula for required revenue converts a hurdle rate into a concrete loan price.

Question 17

The Bank for International Settlements publishes the Basel capital framework referenced in RAROC discussions.

TRUE

The BIS publishes the Basel framework that underpins regulatory capital rules distinguished from economic capital.

Question 18

The standard RAROC formula subtracts the return on economic capital in the numerator.

FALSE

Return on economic capital is added in the numerator, while expected loss is what gets subtracted.

Question 19

RAROC is used for capital allocation, performance measurement, limit setting and portfolio exit decisions.

TRUE

Banks apply RAROC across these four portfolio-level decision areas beyond simple accept-reject calls.

Question 20

A RAROC value exactly equal to the hurdle rate means the deal destroys shareholder value.

FALSE

A RAROC equal to the hurdle rate is value-neutral; value is destroyed only when RAROC falls below the hurdle rate.