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Why isn't RAROC universal?

Introduction:

RAROC (Risk-Adjusted Return On Capital) is a 40-year-old concept. To its followers, its value is unquestioned. But the institutions that have fully implemented it remain an admired minority. Indeed, the limited use of RAROC is at odds with both its reputation and the millions of hours of effort spent by banks on risk-adjusted performance measurement without embedding it in their DNA.

It is an inescapable conclusion that RAROC projects don't quite live up to their initial promises. Instead of delivering a ubiquitous risk-adjusted performance metric or an embedded behaviour of optimising returns, projects commonly end with modest tweaks to existing systems and the transmission of known business problems to a new generation.

Forty years of trying has, however, taught RAROC practitioners points that should be considered if their projects are to have a better than even chance of lasting success. The purpose of this paper is to share some of those considerations.

Consideration 1: If you want RAROC to be adopted, be sure of the reason why.

RAROC is a political tool, as much as it is a financial one. In a growing market RAROC is used either to justify or deny lending that Credit or Treasury were uncomfortable with. Most organisations have long-standing 'problem' businesses. These are the ones that challenge risk appetite but are core to strategy; or have awkward histories and as many backers as doubters. Any RAROC project needs to be clear about whether and how its output will influence those long-standing debates. Relying on the project to generate an analytical 'answer' is a common project derailer.

A separate topic under the broad heading of rationale is whether RAROC is intended for use in periodic management reporting; in customer pricing; or as part of an organisation's strategic review. The first of these outcomes is often the most time-consuming and an upfront assessment of the trade off between benefits and challenges can help.

Consideration 2: It's never really about the models. It's about consensus.

Risk models are useful, risk models are a regulatory requirement but risk models are not the be-all and end-all of any RAROC project. Indeed, if an institution's discussion about RAROC becomes a discussion about the quality of risk modelling, many of the arguments about its value will have already been lost. Banks that use RAROC do so with faith – they make relative judgements on the basis that the signal coming from their RAROC models is good enough to support their efforts to compete in the market. For that faith to be present, there must be consensus that the models are 'good enough', which typically means that they back-test in sensible ways against market pricing. Seeking modelled perfection is unwise and often unachievable.

Consideration 3: Stability is all-important.

This cannot be over-stressed. RAROC contains technical elements. If those elements move too far from period to period (better analytics delivering different outcomes) and if those elements move too far between plan and actuals, then please see Consideration 2. No RAROC project should consider changing the metrics more often than the bank changes its financial targets and the two should move in harmony (preferably with future RAROC metrics being settled before the plan is set).

Note that this doesn't mean RAROC should be unaffected when credit cycles swing. It means that taking a point-in-time approach to risk model parameters can be problematic. Businesses want to hedge their metrification risk in the same way that they hedge interest rate risk – for the life of their portfolios. If a BBB loan has a RAROC of 14% on day 1 then it should have a RAROC of 14% on day 701 provided the customer and bank debt ratings have remained the same over the period.

Consideration 4: Business models matter.

One reason why RAROC can be challenging to embed is the inherent difference between the way in which risk models are created, which is often by product, and the way in which businesses seek to operate, which places the customer at the heart of any transaction. Creating analytical bridges between the two perspectives is challenging and a common reason why introducing RAROC into business performance reporting takes more time than anticipated.

There are two additional business model considerations that, if addressed early in any RAROC project, will prevent problems later on. The first is clarity about the value of the deposit franchise. The introduction of liquidity regulations, including the Liquidity Coverage Ratio and Net Stable Funding Ratio have changed the dynamic for deposits. Early RAROC models barely considered deposits, seeing their value at best as static, while focussing exclusively on the asset side of the balance sheet. Such an approach is no longer appropriate and a valuation and pricing mechanisms that support active management of liabilities are now obligatory elements of any RAROC project.

The final business model challenge emerged as the language of risk extended from the customer-oriented credit and market risk to include the broad range of process-derived operational risks. Decisions about how back-office operational risk should be assigned to front-line business decisions can be just as influential as decisions about allocating back-office costs.

Consideration 5: For RAROC to be relevant, a bank's real constraints must be acknowledged.

Even if a RAROC project addresses the first four considerations it may still not achieve its ambition of delivering a ubiquitous, embedded, sophisticated performance framework. The final hurdle to be overcome is one of relevance. All institutions operate within a series of constraints. The clear constraints – such as regulatory-enforced leverage ratios – are often less powerful than the anecdotal constraints, which can often relate to cost control or to investment spend. No RAROC programme can solve these problems on its own, just as no RAROC programme can resolve long-standing debates about the relative merits of different businesses or portfolios (see Consideration 1). However, successful projects are often those which are clear about how their outcomes can influence cost growth and investment decisions and which set time and resources aside to manage this critical dependency.

How can TORI help?

Organisations will reach their own answers to the questions raised above. TORI has designed a dynamic process that responds to these answers and sets out clear steps to deliver a RAROC culture. We can support a project from conception through to completion, assisting with IT, analytics and reporting solutions.

About TORI

It takes courage to embrace change and transform your business. We know. We've been there. That's why we set up TORI Global. To be a credible alternative to the 'big four' within Financial Services – by putting real industry experience at the heart of consultancy. So our clients get the best independent advice and specialist expertise for the success they deserve.

We are truly global. Headquartered in London, with offices in New York and Dubai and recent expansions into Bangalore and Singapore, there is a TORI network across the globe with aggressive growth plans.

At TORI Global we believe that delivering success for customers relies on successful partnerships, and that successful partnerships are founded on the values of Trust, Openness, Respect and Integrity.

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