RISK MANAGEMENT

RAROC on the Rise

More firms are analyzing revenue in relation to risk by using RAROC calculations designed in house. Will the vendor community jump in the game?

BY CRAIG MCGUIRE

With financial services firms constantly searching for ways to effectively analyze revenue in relation to risk exposure, a number of companies are throwing their weight behind technology related to Risk Adjusted Return on Capital (RAROC) calculations.

Newton, Mass.-based Meridien Research recently tracked five financial services firms currently involved in various RAROC-related projects. Though IT officials at these firms, with combined assets topping $1 trillion, decline to discuss their fledgling deployments, WS&T was able to ascertain the nature of their projects.

As things are beginning to settle down following a re-org initiated by new Chairman and CEO John Hunkin, Canadian Imperial Bank of Commerce (CIBC) is in the midst of an enterprise-wide rollout of a RAROC system. First Union, with some $230 billion in assets under management and total stockholders' equity of $16 billion is deploying a RAROC system to better view product and client profitability with its segments and major business lines.

Dutch powerhouse ING Group plans to use RAROC to support consistency in policies and reporting across its banking, insurance and asset management groups. Key Corp. has already experienced success with its RAROC deployment in the form of return on its equity for all of its various lines. And then there's the General Risk Analysis Computer Environment (GRACE) system developed by Swiss Reinsurance Corp. to analyze its main categories or risk dependencies between these categories.

The underlying concepts are not exactly earth shattering. In fact, RAROC processes are simple calculations that have been used by financial services firms for over 30 years. "The RAROC calculation is a relatively straight-forward equation that evaluates the relationship between risk and revenues," says Meridien's Deborah Williams, the research director that authored the report. "There are three things you need to know to do RAROC—what the return is, what the risk is and what the capital number is."

Williams explains that the complexity doesn't lie in the RAROC calculations themselves, but rather in the underlying technology that draws the information and the first level of calculations that compile the figures used to perform RAROC. "Frankly, most RAROC calculations today are done on relatively simple spread sheets," says Williams. "But the complexity comes when you have to drill it down for individual products, businesses and even business lines—then you have lots of numbers.

"RAROC is an incredibly powerful management tool and is relatively easy to calculate if the underlying infrastructure is in place," says Williams. "The biggest challenge in a RAROC implementation is aligning the data from the risk engine and from the financial systems."

With the technology to support these initiatives remaining a relatively new phenomenon, to date all deployments have been solely internal projects, with no assistance from the vendor community.

"The relatively small amount of spending on RAROC [related technology] today is about to explode as RAROC becomes recognized as a major factor in both product pricing and institutional performance," Williams predicts. "But, spending on RAROC calculations will never be that high because it's a simple calculation. It's the spending on the underlying infrastructure that's sure to increase dramatically. It's already happening." ■