

## Using RAROC To Manage A Business

*Kerry Williams*

How do you roll RAROC out to the business line, and what are its practical applications? These are questions that we hear frequently, and I thought I'd answer them by sharing one of my key experiences as a senior manager at Bank of America.

During the mid-1990s, I was responsible for the commercial card division at Bank of America, which encompassed small business, purchase, corporate and fleet cards. These products seem similar, but a look at the risk characteristics of 'purchasing' versus 'corporate' cards reveals a different story.

Bank of America launched the purchasing card product in 1995 to help corporations procure low-value items more efficiently than they could by using traditional purchase orders. The product was phenomenally successful and, with revenue based on fee income of around 2% of each transaction, the cards became one of the most profitable products in the bank. The RAROC, or risk-adjusted return on capital, results for the product were particularly strong because:

- Customers would often select a seven or 14-day credit cycle, and then pay within five days of the cycle cut-off, which limited market risk. This also meant the cards were really a cash management product that attracted little credit risk capital.
- There was often one main point of contact with the corporation, with cards issued to only a small number of high-use cardholders. This limited the cost of servicing the cards.
- The small number of cardholders, mostly based in the US, reduced operational risks such as fraud risk.

Given our success with the purchasing card product, we decided to launch a corporate card product that would compete head-to-head with American Express. When we'd developed some key attributes and a pricing strategy for the new product, we ran these by our finance group at corporate headquarters to obtain a forecast of the business's RAROC numbers – expecting the returns to be similar to those of the purchasing card product. Boy, were we wrong! Our projected RAROC results were half those of the purchasing card product, for these reasons:

- **Credit risk:** To be competitive in the corporate card market, institutions must often agree to issue cards to individual cardholders, who then become responsible for repayments. Some large customers don't even allow credit scores to be run

on their designated cardholders, all of which leads to a higher level of expected loss from credit risk.

- **Operational risk:** Corporations expect every traveling employee to carry a corporate card, which can mean issuing more than 20,000 cards per corporate customer. As well as the greater risk of cardholder fraud, cards can be lost or stolen in the US mail. Additionally, the bank has to deal with thousands of remittances from individual cardholders.

- **Fraud risk:** Many corporate card customers were likely to travel abroad, where the infrastructure of Visa and MasterCard would not support the sophisticated electronic fraud prevention measures available in the US.

These risks meant that much more capital had to be assigned to the corporate card business. The RAROC analysis showed that while the product would be profitable, and exceed the bank's hurdle rate, it would have a negative effect on the RAROC performance of my division. This was important to me as my performance measures (a balanced scorecard) were based in large part (45%) on my RAROC performance.

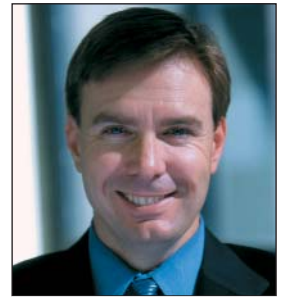
The RAROC analysis helped me to adjust my management actions. In competitive bids involving the corporate card product, I decided to be less aggressive in terms of price-cutting.

I also explained to my group executive that while my division's results would increase on a net income basis, they would fall on a RAROC basis (even though the new business made sense for the bank, as the returns exceeded the corporate hurdle rate). The bank reset my RAROC goal to a lower level to account for this dilution.

The RAROC analysis showed that I should plough any incremental resources into the purchasing card product, rather than the corporate card product, all other things being equal.

I was so impressed with the power of the RAROC methodology that when the opportunity presented itself, I jumped! I left Bank of America in 2000, to become the President of ERisk, where we specialise in RAROC analyses to help our customers gain similar insights into their lending and pricing decisions.

*Kerry Williams can be contacted at [kwilliams@erisk.com](mailto:kwilliams@erisk.com) and on telephone number 917.522.1625.*



**Kerry Williams**  
President of ERisk

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ERisk, 1155 Avenue of the Americas, New York, NY 10036, USA  
Tel: 212.819.0170  
Fax: 212.819.0171