# The Relationship between Risk Capital and Required Returns in Financial Institutions: Some Preliminary Results*

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## Abstract

We use arbitrage arguments to characterise the relationship between required shareholder returns and the exposure to downside risk, as measured by VaR at stated confidence level and time horizon. We show that skewness and diversification have a major impact on zero-NPV RAROC (return on capital) hurdles, implying that use of return on capital with a constant hurdle rate can lead to substantial loss of shareholder value. We propose an alternative performance measure consistent with standard valuation models and discuss implications for prudential regulation.