

UK Financial Services Practice

Lessons from Basel II

Institute of Risk Management

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Agenda

- ▶ **Based on our experience delivering Basel II across the Capital Markets (HSBC, RBS, Barclays, UBS, Macquarie, Standard Chartered, Citigroup)**
- ▶ **Focus on 4 main areas;**
 - **Programme Structure & Governance**
 - **Technology Strategy**
 - **Data Quality & Management**
 - **Resourcing**
- ▶ **“Solvency 2: Lessons from Basel II - December 2009” available in full at; http://www.p-fg.com/pdf/Lessons_from_Basel_II.pdf**

Programme Structure & Governance

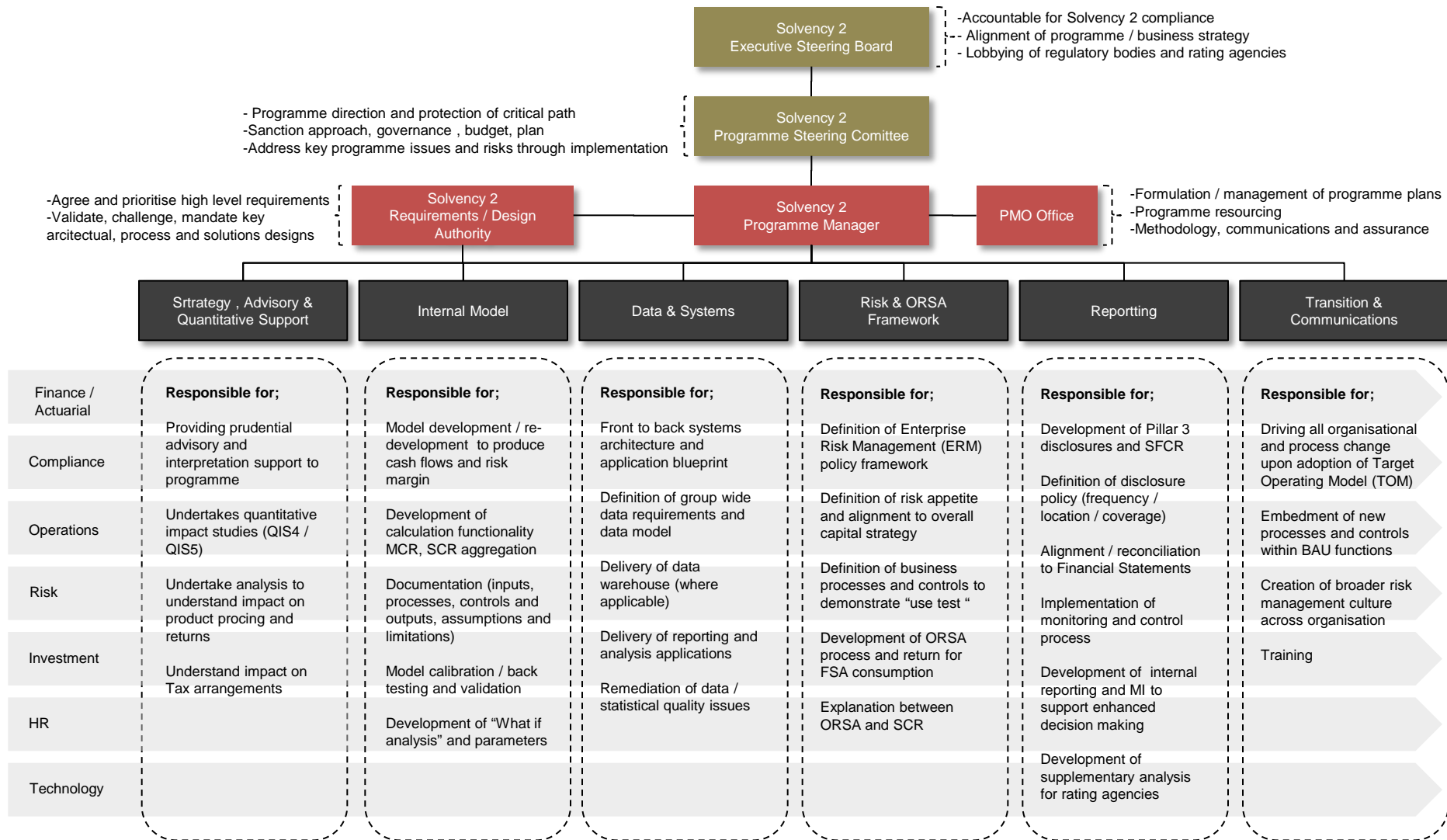
- *Boundaries between group and divisional programmes initially blurred due to;*
 - *Disputed responsibilities*
 - *Poor and infrequent communication*
 - *Ambiguity in programme strategy and critical path activities*
- *Major frictions between various functions (primarily Risk, Finance and Technology)*
- *Key challenge was implementing right level of governance, oversight and efficient delivery model*
- *Regulators particularly interested to understand programme structure, underlying plans, resources and governance*



Key Lessons

- *Articulate how Solvency 2 aligns to strategic priorities of firms and benefits.*
- *Lead from the front - don't be dragged by a particular division.*
- *Excellent opportunity to rationalise and integrate governance structures.*
- *Establish a Requirements & Design Authority to manage evolution in policy*
- *Ensure Steering committees are issue driven focussing on "How" not "What"*

Establishing and efficient governance structure is critical to the successful delivery of Solvency 2



The most common mistake made by many banks was to significantly underestimate the scale of data quality problems and the level of effort required to resolve them

Data Quality & Management

- *Disproportionate effort paid to perfecting capital algorithms as opposed to quality of model input data*
- *Existing processes not sufficiently robust to meet regulatory expectations or Enterprise Risk Management objectives*
- *Unresolved issues subsequently driven up operating costs and capital levels capital*
- *Regulators particularly interested to understand data quality improvement plans and progress.*



Key Lessons

- *Information quality will play a key part in gaining strategic and operational advantage e.g. Pricing.*
- *Imperative to establish golden source – minimise data sourcing / acquisition where possible*
- *Remediation should be the responsibility of the business owner e.g. Relationship Mngr not the programme*
- *Granular allocation of capital within the firm will incentivise managers to act*
- *Data Model should consider Internal Model, ORSA, Pillar 3 and MI requirements*

Meeting Basel II requirements raised significant challenges for firm's information technology requiring, in some cases, the complete redesign of Bank's Enterprise and IT architecture

Technology Strategy

- *Key design decisions over Centralised vs. Federated architecture , in-house vs. 3rd party build*
- *Existing systems and data sources overlooked in favour of*
 - *Leading to over Investment*
- *Banks underestimated the cost of performance and ability for industrialised solutions to process firm wide data.*
- *Due to enriched and granular nature of data banks increased significant demand from business stakeholders*
 - *Resulting in immense pressure on reporting*



Key Lessons

- *Firms should take a long term, and enterprise wide, view when considering the use of an internal model Target Architecture*
- *Should consider how architecture decisions will be impacted by any future corporate activity e.g. M&A.*
- *Firms adopting the internal model approach should also look to incorporate standard formula calculation functionality*
- *Solution design should support aggregation and disaggregation of risk and capital on a variety of hierarchies e.g. Product*

One of the major issues faced by banks throughout Basel II was their ability to attract and retain expert resource. Individuals with in-demand skills were required simultaneously by banks

Programme Resourcing

- *Firms who were slow to mobilise paid the greatest price.*
- *Skills shortage resulted in significant increases in rates and deterioration in quality – increase in programme delivery risk*
- *Initial focus was development of credit models – real issue was Pillar 2 resource*
- *Similar issues now faced by Insurers compounded by competition from banks*



Key Lessons

- *Firms should include programme resource as part of their initial GAP analysis*
- *Seconding BAU resource is an effective way of mitigating flight risk and retaining knowledge.*
 - *Change should be delivered by change professionals*
- *Firms should consider a retention provision for all key external contract hires payable upon completion of tenure / deliverable.*
- *High calibre individuals typically work with specialist firms, not general providers of contingent resource. Insurers should assess there providers accordingly.*

If one lesson can be drawn from the implementation of Basel II it is that the role of the Chief Risk Officer and the Risk Management function has never been more important

- ▶ ***Delivering change of this magnitude has deep and far reaching implications within organisations, no matter how large or small, and should not be underestimated***
- ▶ ***Firms should look beyond the opportunity to simply reduce capital requirements and seek to leverage their Solvency 2 investment in order to instil an enterprise wide, risk management culture***
- ▶ ***History has taught us that black swans do exist; however, if firms embrace Solvency 2 and focus their efforts equally upon risk quantification and governance then the impact of these future events should be greatly reduced***