

Basel II an overview

Institute of Risk Management

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A history

- Basel I – the 1980's
- The 1990's – Leeson et al
- Basel II and the emergence of EWRM
- The new capital regime

The landscape has changed!

.....the era of the CRD....the implementation of a EU wide, modern, risk sensitive prudential framework aligned to the risk profile of firms operating in the financial markets.....

“A predominance of rules aligned to core regulatory principles”

SYSC – A firm’s business plan and risk management systems should;

- anticipate future risk environments;
- include stress testing and scenario analysis on financial resources;
- determine risk appetite and limits; and
- maintain sufficient capital and liquidity throughout the planning horizon – for most firms this is 3 to 5 years.

Terminology

- Pillar I
- Pillar II
- Pillar III
- ICAAP
- CRR
- Standardised approach
- AMA
- IRB

1 January 2008 - CRD came into force

- Pillar 1 Minimum capital requirements
- Pillar 2 ICAAP
- Pillar 3 Disclosure

The options

- Standardised approach
- IRB
- Advanced measurement approach

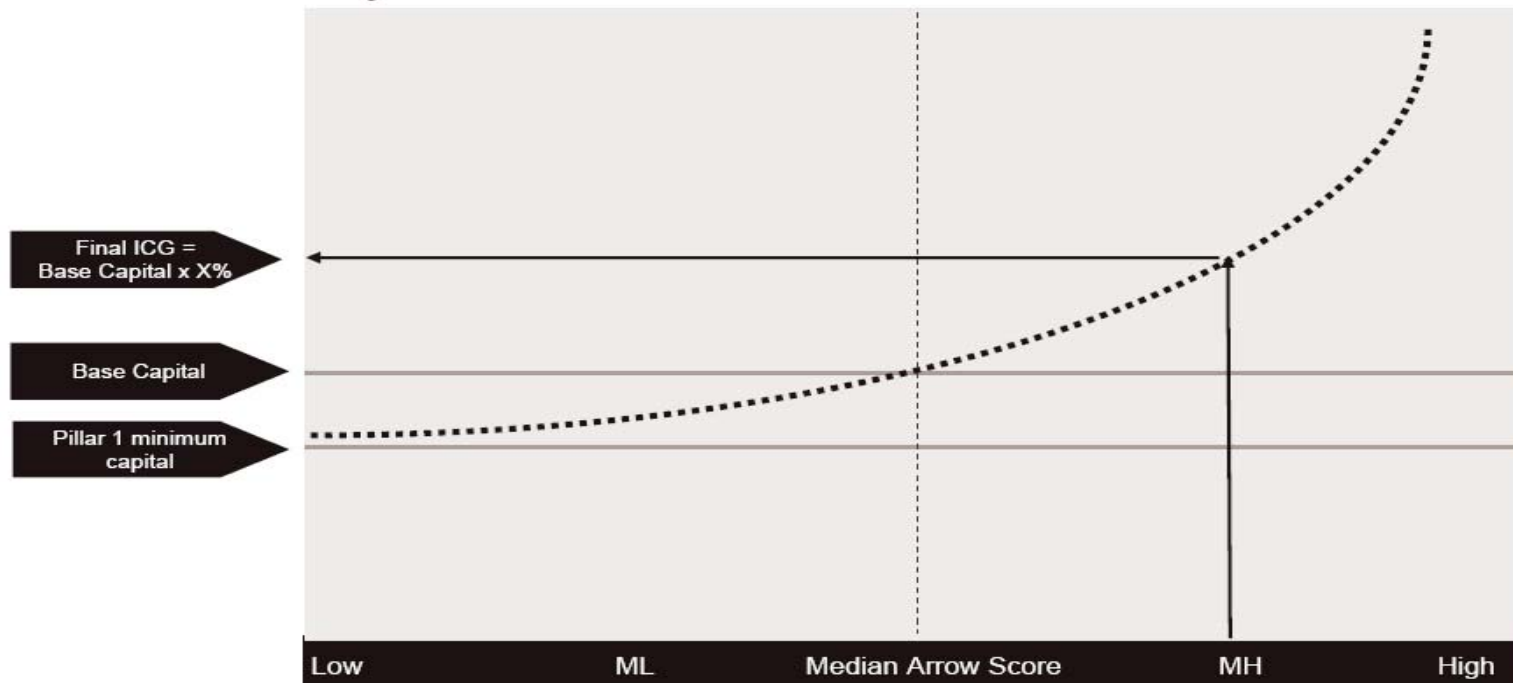
Key requirements

- Pillar 1 risks – Focus on operational risk and credit risk - with defined models. Effectively the old Basel 1 with new tools and self determination. Derivation of the CRR of 8% of newly defined risk assets. The outcome of the standardised and IRB approaches.
- Pillar 2 risks – shortcomings in operational and credit risk models under pillar 1 and addition of all other risks. ‘Stressed’, forward looking and quantified i.e. the ICAAP – must consider capital/decision making/governance/adequacy/appetite – onus on evidence and timing.
- Pillar 3 – disclosure - potentially revealing how you did it or how good you are at doing it - transparency!.....market levelling and investor led.

Linking the qualitative assessment to capital estimation



Adjustment can be less than 100% but cannot fall below Pillar 1



Risk Appetite - the starting point!

“The amount of a risk an organisation is prepared to take in pursuit of value”.

or

“The size of the bet a firm is willing and able to place in pursuit of its strategic aims”.

Measured by quantitative and qualitative techniques....but moving towards an economic capital view of the choices available - reconcilable to regulatory capital!

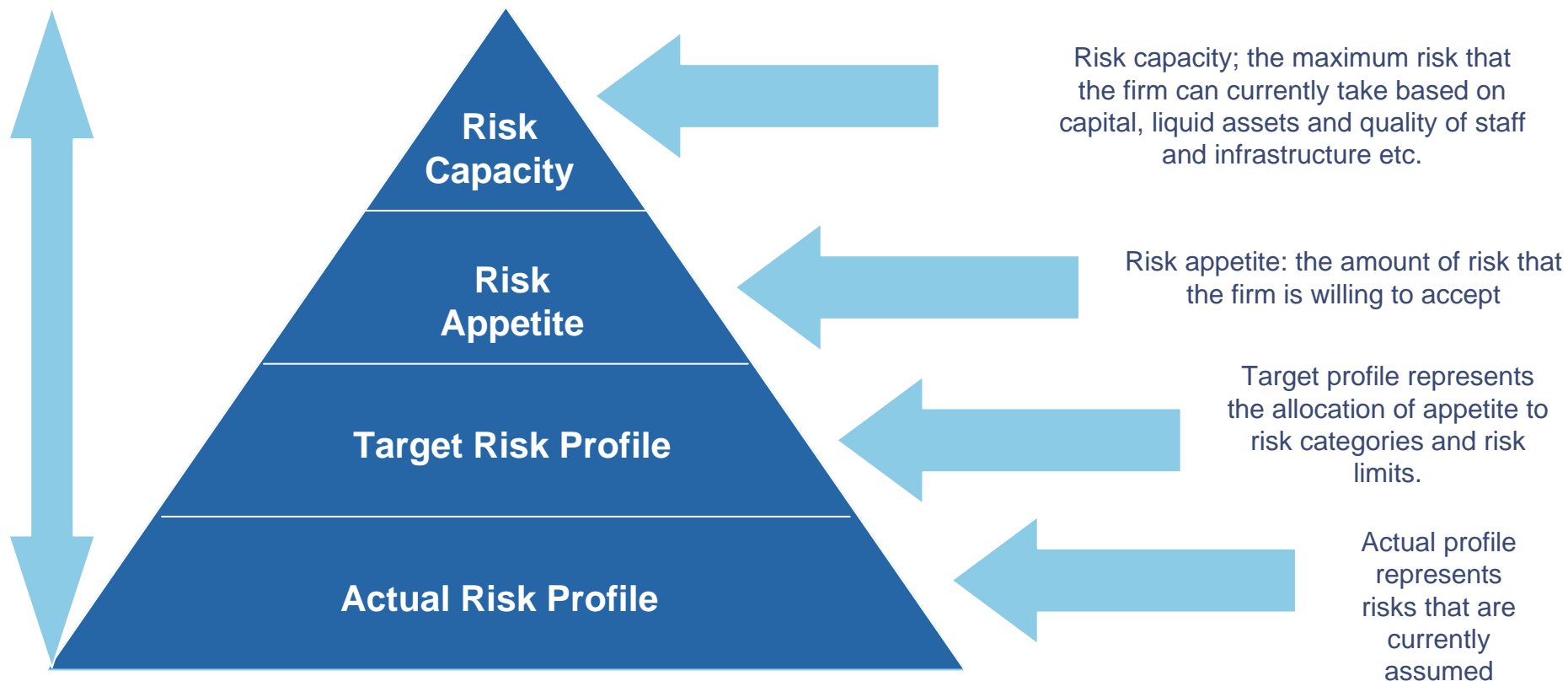
Whose Risk Appetite?

Different stakeholder perspectives:

- The Board's
- Investors/members - safety and profits – balancing act
- Rating agency - aspirations
- The regulator's view – likely to differ from the firm's?

A combination of all of the above.

An approach to risk appetite - a “top down” “bottom up” activity!



Linking risk appetite to the business activities of the firm

- The Board must periodically review and define its risk appetite – strategic planning is a good time to do this.
- Establish consistent methods of calculating risk capital requirements by risk type across each business.
- Set Board Policy to define risk limits in the context of risk appetite considerations to influence business decisions.
- Monitor through appropriate MI

Best practice

The regulator's perspective

‘A firm must take reasonable care to organise its affairs responsibly and effectively, with adequate risk management systems’.

‘A firm must have robust governance arrangements, which include a clear organisational structure with well defined, transparent and consistent lines of responsibility, effective processes to identify, manage, monitor and report the risks it is or might be exposed to, and internal control mechanisms, including sound administrative and accounting procedures and effective control and safeguard arrangements for information processing systems’.

It is not just about calculating a complex capital number!

The regulator's perspective

'The senior personnel of the firm must approve and periodically review the strategies and policies for taking up, managing, monitoring and mitigating the risk the firm is or might be exposed to, including those posed by the macroeconomic environment in which it operates in relation to the status of the business cycle'.

'Senior management must have a good understanding of the risk methodologies in use'.

(Question – how comfortable are those in the room with regard to their knowledge of the their organisation's risk and governance practices and could they articulate it to the regulator).

'A firm must measure and manage all its risks'.

Best practice

Use test - BIPRU 4.2.2

.....internal ratings and default and loss estimates used in the calculation of capital requirements and associated systems and processes play an essential role in the risk management and decision-making process, and in the credit approval, internal capital allocation and corporate governance functions of the firm.....

Best practice

What is on the regulator's mind at the moment?

- Robustness of stress testing – still seeing complacency resulting from benign conditions.
- The extent to which firms model the impact of environmental factors on inherently concentrated portfolios (BSocs in particular – profits, liquidity and capital).
- Use test – too form driven and still an intellectual exercise for many firms – no link between models and lending decisions!
- Positive correlation is OK when properly justified!
- The principles start/imply with a well diversified firm – don't forget!
- Flu pandemic – firms failures to plan for this (contingency more generally too)

Pillar 3

The purpose of Pillar 3 – market discipline – is to complement the minimum capital requirements (Pillar 1) and the supervisory review process (Pillar 2). The Committee aims to encourage market discipline by developing a set of disclosure requirements which allow market participants to assess key pieces of information on the scope of application, capital, risk exposures, risk assessment processes and hence the capital adequacy of the institution.....disclosures should be consistent with how senior management and the board of directors assess and manage the risks of the bank.

(Basel Accord – Part 4 – June 2004)

Pillar 3 – General requirements

Disclosure requirements regarding...

... Assessment of „performance“

Qualitative Information

- Description of processes
- Description of methods
- Description of approaches
- Description of procedures
- ...

... Assessment of „exposure to risk“

Quantitative Information

- Indication of capital
- Indication of risk-assets
- Indication of collaterals
- Indication of provisions
- ...

Pillar 3 – General requirements

Risk management objectives

- § The strategies and processes
- § The structure and organisation of the relevant risk management function
- § The scope and nature of risk reporting and measurement systems
- § The policies for hedging and mitigation risk
- § The strategies and processes for monitoring the continuing effectiveness of hedges and mitigants

Scope of application

- § The name of the credit institution
- § An outline of the differences in the basis of consolidation for accounting and prudential purposes
- § Information from firms, which are
 - § fully consolidated,
 - § Proportionally consolidated
 - § deducted from own funds; or
 - § neither consolidated nor deducted;
- § Impediment to the prompt transfer of own funds

Own funds / Capital adequacy

- § Summary Information on the terms and conditions of the main features of all own funds
- § The amount of the original own funds , with separate disclosure
- § The total amount of additional own funds
- § Deductions from original and additional own funds
- § Total eligible own funds

Risk exposures

- § Credit Risk
- § Market Risk
- § Operational Risk
- § Equities
- § IRR in the banking book
- § Securitisation

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