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REPORT

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Make Basel-II work for you

Viewpoint

Banks can gain competitive advantages if they respond positively to all aspects of the Basel II accord

But getting the full benefits will mean overhauling procedures in an unexpectedly wide range of operational departments.

Basel-II GOALS:

1. Align capital required to risk exposure
2. Strengthen bank supervision
3. Broaden disclosure

Dynamics

- Instead of a blanket 8% requirement the new accord allows capital reserves to be aligned to actual risk and operational exposure.
- Companies' capital requirements can be further reduced if they comply with advanced risk and operational control methodologies
- Managers in many departments must become involved in planning and implementing your enterprise's response to the Basel-II accord

Predictions

- Most financial service providers will fail to generate a sense of urgency in the departments that will need to change
- Few companies will qualify to receive the maximum reductions. Those that do will have a major competitive advantage

Recommendations

- **Decide now whether to bid for the full benefits** and take urgent steps to demonstrate your ability to comply by 2004
- **Appoint a senior team to lead from the top**. The weakest link in your operations will affect the rating of your whole business.
- **Raise awareness and make operational managers participate** Launch a full program of staff education urgently.

Ralph Silva
With Graham Taylor

"Qualifying to use the advanced methods of risk assessment reduces capital requirements, but also offers potential cost savings and revenue opportunities."

Viewpoint

Early compliance with the Basel-II accord has two advantages

The Basel II capital adequacy accord will affect all banks and most security firms and asset managers. Its requirements look certain to be adopted by the regulators in all G-20 countries in 2006. It changes the level of capital required in respect of risks from lending operations, but also requires companies to demonstrate their control of operational risks. Compliance could require a complete overhaul of current operations.

Many companies see the new requirements as onerous, but believe that they have four years to demonstrate compliance and are not rushing to make changes. This attitude overlooks the two key opportunities that the new accord creates:

- Companies that demonstrate their ability to comply by 2004 will qualify to use advanced methods of calculation that dramatically reduce capital requirements.
- Compliance procedures clearly identify the risks associated with specific clients and processes. This information can be used to develop new marketing initiatives that increase revenues, or to change processes in ways that reduce costs.

Companies that wish to obtain maximum advantage will mobilize immediately to ensure that they demonstrate their ability to meet the accord’s requirements by or before 2004.

Dynamics

Compliance can significantly reduce capital requirements

The Basel II accord is a far reaching regulatory initiative designed to accurately align liquidity level requirements to actual risk while strengthening supervision and broadening disclosure. It will supercede the 1988 accord which introduced risk controls into the lending operations of international financial service companies to protect clients against banks that were severely undercapitalized. Both accords were developed by a committee of national regulatory bodies under the coordination of the Bank of International Settlement.

The new Basel Accord addresses the inherent problem of its predecessor, which set the minimum capital requirement at 8% of the risk-weighted assets regardless of the nature of the actual risk. The capital has to be held in common equity or disclosed reserves.

- A loan of $10 million to a purely speculative startup requires reserves of $800,000 under the current regulations
- At present a loan of $10 million to an “aaa-rated” corporation such as Sony also requires the bank to hold $800,000 despite the relatively low risk
  - Under the new accord’s basic rules this would be reduced to $160,000

These reductions are significant, but can only be achieved if a bank qualifies to use the more advanced methods of risk computation that the Basel-II accord provides.

To gain maximum advantage you need to qualify

The Basel-II accord accommodates three different methods for determining risk. The basic method is based on market ratings while the two advanced methods require that you demonstrate adequate internal credit and operational controls. It is clear that the accord is designed to encourage advanced risk management practices and to increase the transparency of risk to the investment community.

The basic, level-1 approach was developed to accommodate smaller, less sophisticated banks that lack strong credit control. It bases capital requirements on credit agencies. As an example, a loan to a Aaa rated corporation (Moody's highest rating) would result in 1.6 cents on the dollar instead of the 8 cents on the dollar of the original Basel accord.

If a financial institution elects to go through the qualification process, it may qualify for one of the two more advanced methods.

- The simpler level-2 foundation system calculates capital requirements based on internal estimates of default probabilities together with regulatory assigned values.
- The more elaborate level-3 approach adds variables such as loss given default, exposure and loan maturity.

A financial services company must select the level that it wishes to attain and assure that all of its operations, both direct and indirect, are in compliance. Approval for the use of ether of these methods will only be granted if at least 2 years of experience and data can be demonstrated to the regulators' satisfaction.

Tracking operational risk is complex but has advantages

The main new feature of the Basel-II accord is a capital requirement associated with operations. This has been added as a provision for losses resulting from inadequate or failed internal governance, human resources or technical systems, and from risk exposure that arises from external events.

As with lending operations, the current proposal for operational risk assessment includes two methods of assessing risk that result in different levels of capital requirement.

- The simplest method associates risk with gross income and specific financial indicators.
- The more elaborate method demands adoption of methods to compute the probability of default for individual systems and operations and the tracking of risks associated with individual clients.

Qualifying to use the advanced method allows capital requirements to be reduced, but also offers potential cost savings and revenue opportunities. As Gartner has explained for many years, companies that implement good measurement programs benefit from

  - greater accuracy in targeting clients with appropriate products
  - improved risk tracking through transparency of operations

Accountability within individual departments and performance can be improved as processes become transparent; for example clusters of similar risks can be aggregated, reducing costs. The process of complying with the Basel-II accord can help you realize these benefits earlier, while delivering large reductions in capital requirements.

Penalties will make late implementation expensive

Implementation of the terms of the Basel-II accord by national regulators is targeted for 2006. In the European Community all member states will require compliance for any financial services provider. It will apply to all banks in the 110 signatory countries and to all firms with lending operations.

- Many financial institutions will implement Basel-II fully by January 2004. By demonstrating two years of experience they will qualify for the more advantageous measurement methods and benefit from the availability of additional capital in 2006
- A penalty system has been proposed that requires an additional year of experience and data for every year of delay past 2004 with a cap at 5 years.

This poses a big incentive to get the operations ready early. Companies that are late will be obliged to run for two extra years with substantially higher capital requirements.

Predictions

- **Most financial services providers will fail to realize the urgency of compliance in departments outside of risk management.**
Banks have traditionally seen risk management as the responsibility of one department or team. The Basel II accord puts risk management squarely in the hand of the whole organization. While Risk Management departments may be ready, the rest of the organization could struggle to grasp the Basel II concepts.
- **Few companies will qualify to receive the most advantageous classification. Those that do will have a competitive advantage.**
The deadline of 2004 may not provide sufficient time for all operations to be reorganized and the necessary measurement systems implemented. Companies that do organize and implement on time, will enjoy lower capital requirements

Recommendations

- **Decide now whether to apply for the advanced classification and take urgent steps to implement procedures.** Different levels of compliance will require different levels of effort. Select the level that will be a target for the whole organization and hold each department accountable for attaining that goal.
- **Appoint a senior team to lead from the top.**
Poor ratings for individual units or businesses will prevent the whole enterprise from using the advanced methodologies and receiving the benefits. The process must be led from the top so that business units that lag can be brought into line.
- **Raise awareness and assign accountability.**
The biggest obstacle to successful compliance with the Basel II accord will be lack of understanding of the potential benefits within the organization. Basel II will require cooperation from the whole firm. The best way to attain that is to assure a common level of understanding. Launch a full program of staff education urgently.