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Challenges and Requirements for adoption of Basel II approach

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Whether to accept the challenge…..

- Basel II is
  - Distant (2007), possibly receding
  - Complex, arguably too complex
  - Still a moving target
  - Will be subject to as yet unknown interpretation by national regulators
  - Publicly questioned by regulators from the US and China
- But it captures the thinking of most regulators
  - Represents the peak of current thinking in the industry on risk and capital
  - Its currency as the chosen BIS model and as future driver of regulatory capital forces discussion throughout the bank of detailed risk issues
  - Promotes key formal discipline in credit and operational risk
  - Formalisation of the internal view of how to aggregate risk and answer the question ‘how much is too much’?
- Most of the gains arise from striving for the advanced approaches

The Basel II Advanced Approach

- Credit Risk
  - Capital requirements are more sensitive to risk
  - Based on banks' internal credit rating system and credit loss history
- Operational Risk
  - Banks can develop their own estimate of the capital required
  - Estimate must be analytical and data-based
- The Alternative
  - The alternative to 'Advanced' is 'Standardised'
  - Standardised for Credit is an extension of existing Accord
  - Basic indicator for Operational Risk is 15% of Gross Income

Credit Risk Capital - Challenges

- Quantification of risk sensitive capital requirements is based on, and must be verified with, actual internal loss data
  - Many banks lack the data
  - Systems and processes for assigning ratings and quantifying risks must be rigorous and independent
  - Hence many banks will not achieve advanced status
- Banking Groups must aggregate credit data in a consistent and comprehensive manner
  - A systems headache for many banks, where there is variety of systems, locations, and business groups

Credit Risk Capital

- However, principles of the approach are sound
- Our experience at Macquarie Bank is that moving in the direction of the advanced approach is consistent with improved credit risk management
  - A robust internal ratings system promotes better decision making and credit monitoring
  - Quantification of credit risk at the portfolio level is essential to aggregation of all risks in an economic capital model

Operational Risk - challenges

- Banks must develop their own internal operational risk model
  - Capital for operational risk is virtually impossible to model and definitely impossible to validate
  - It is possible to develop a model which tells a bank nothing useful about operational risk
  - A model for operational risk capital must not be confused with reducing operational risk – the latter requires changes to processes and systems, not just a measurement model

Operational Risk

- However, focusing more attention on op risk, and promoting a systematic attempt to quantify op risks can be beneficial for op risk management
- Aiming at presenting the bank's operational risk profile in the style of credit or market risk profile, is a laudable goal
- Our experience at Macquarie Bank is that the Basel II requirements to achieve advanced status are consistent with better operational risk measurement eg
  - Reliable op risk incident reporting is an indicator of op risk issues
  - Key Risk Indicators help direct internal audit priorities

Model acceptance

- Supervisors must review and accept the internal models used by banks for the advanced approaches
  - Many supervisors say they lack resources to do this
  - Supervisors will be naturally sceptical about models which generate lower capital requirements for banks
  - But will still wish to promote better risk management

Overall

- The Basel II advanced approaches, particularly for credit risk, are based on sound risk management principles which are an appropriate target for banks to achieve
- However, Basel II also sets very high demands for quantification and verification which will be difficult, and often expensive, for banks to meet
- Banks face the possibility of working towards implementation of advanced approaches from which they may obtain improved risk outcomes but not recognition by regulators