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New Standards for Risk Management

Also in this issue

PROJECT MANAGEMENT ISSUES SPECIFIC TO IMPLEMENTING BASEL II

In this article Tony Scrace, FCA Chartered Accountant, risk manager and banker for over 25 years, draws upon his experience as Project Manager for Lloyds TSB International Banking Basel project and his support role of the Lloyds TSB Group Project in relation to Data Accuracy when offering advice to those who might be embarking on similar missions in their banks.

The Basel II implementation project presents all the usual project management problems that a bank normally faces, together with as a few of its own. This article details some of the issues that Basel project managers are likely to come across in the course of their work.

Different Regulatory requirements

Basel II is being implemented across the globe and even though the underlying principles set out in the BIS documentation are being followed, Basel II is being implemented at different speeds and in different ways in different countries. The rules themselves are continually evolving and different regulators take different approaches to the same issue. This can make life difficult for a subsidiary of a multinational financial institution which needs to meet the regulatory requirements of the head office's regulator, the local regulator and is probably using a third system to decide the risk parameters for commercial decision making. If at all possible it is worth looking at designing a system which at least collects the information needed for all the actual and potential users of the risk data in a single process. A little foresight can result in significant future savings.

Competing priorities

Implementation in each country starts with the local implementation of the BIS documentation which is then developed into legislation. This legislation is then implemented under the guidance of the local regulator. Within each country the individual banks may have some leeway as to how they implement Basel II, but this can vary considerably from some regulators taking a strict adherence to detail approach whereas others are more concerned about principle. Each of these stakeholders has different priorities and focus. The regulators are most concerned with avoiding damaging bank failures that might result in the failure of another financial institution. They may also be seen as being in competition with other regulators and can also be influenced by national pride. On the other hand, bank senior management may be looking to increase profits or to maintain their perceived competitive position. These competing priorities make it difficult for the Basel II implementation team to make choices which will keep everyone happy. Therefore it is important to sort out early in the project life cycle what the regulator really wants, how the bank is going to meet that requirement and use that data to manage the business effectively.

When Basel requirements are implemented much of it will be new and few people, including the regulator, will be quite certain what is acceptable


Basel Committee on Banking Supervision

International Convergence of Capital Measurement and Capital Standards

in terms of systems, documentation, data accuracy or what certain aspects of the legislation actually mean. The consequences of this include the fact that many systems have been built by banks which have subsequently been found to be unfit for purpose and considerable costs has been incurred doing the work all over again. The need to keep step with regulatory demands has necessitated extensive discussion between banks and regulators about what is required. Try to keep your regulator informed and point out when you see that the decisions they have made are resulting in unintended consequences.

It is massive

The documentation is voluminous with

thousands of pages of text issued by BIS, supplemented by many new additional papers. This is supplemented by papers from the Committee of European Banking Supervisors, local regulators and other bodies. It is easy to get lost in the detail and trying to keep track of evolving regulatory guidance can be a thankless task. The UK regulator has developed a good structured approach with extensive glossaries which help a lot, but these can also confuse. The interaction of all these rules can have surprising and unforeseen consequences. Individuals implementing these rules can easily stumble down blind alleys or misunderstand the regulations. It is always worth getting someone independent to check the interpretation that your firm is placing on a regulation. Calculation errors in work conducted can easily lead to Capital Requirement calculations being materially inaccurate.

Data

Data is one of the big issues of Basel II because raw data, mainly customer data, is at the heart of the calculation of the capital requirement. Under Basel I the data required for the calculations was mainly summarised financial data; now vast amounts of detailed customer data is needed to calculate the factors. The two big issues are data availability and data accuracy. For many of the Basel models, data is required which goes back five or more years - but banks have not collected the required data over the required time period so the data is just not available. This makes building and proving your model much harder. Data accuracy is an issue because if you are going to use this data to calculate the capital requirement the calculation is only going to be accurate if the source data is accurate and ensuring this is much more difficult than people realise.

Consistency across the business

The number of decisions which will need to be made by all levels of the implementation will be enormous and it is essential that responsibility for decision making is clear. Good central support and advice can help by allowing for the sharing of best practice so that decisions can be made consistently across the organisation. So you need the continued support of senior management to get a successful implementation.

One for the Accountants

Reconciling the Basel II numbers including capital required, risk weighted assets and capital charge on a management basis, a statutory basis and preparing the solo consolidations are always time consuming activities. Make sure when you are designing the system that you have collected the data which will allow you to complete these exercises.

Change and Stress Testing

Regardless of the project that you are running there will be need for continual change. Such change may arise due to the changing obligations posed by regulators both locally and internationally. Further the expectations of management and the regulators will also be changing placing additional demands. The increased focus on the softer data areas of risk appetite, stress testing and scenario modelling all place challenges which need to be faced. It is these areas where action can save the financial institution under times of real stress.

However it is important to make sure that the management understand what stress testing and scenario analysis can achieve –and what it cannot. They need to take ownership of risk appetite and understand that it is a business driver, leading to improvement of the business. At the heart of the issue is that a failure to get sufficient management buy-in will lead to a failure of the project and could indeed be a career limiting event.

Last Thoughts – Smoothing the way

Wherever you have got to in the process of implementing Basel II it is well worth getting an independent audit / review of the operating model, calculations, documentation and functionality.

A review could easily save you millions by helping to avoid various issues including:

1. Project rework or delay because
   a. the final system is unfit for purpose
   b. essential data items have not been collected by the system
   c. the underlying data is not accurate
   d. the legislation has been misunderstood
   e. sub optimal options have been select, e.g. risk weighted calculation options
   f. failure to convince the regulator that the total operating model including management control is sufficient

2. Wasting resources on unnecessary project work
   a. building an expensive system to reduce risk weighted assets using collateral when the collateral is of insufficient quality to be recognised by Basel II
   b. not using cheaper options for smaller portfolios

3. Incurring penalties (including fines, requirement to hold more capital, etc.) for not meeting regulatory requirements and deadlines.

4. Delay in taking advantage of possible capital savings.
5. Damage to reputation or competitive position if other banks are more advanced

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