Banking & Capital Markets

Getting the most out of your Basel II efforts*

Basel Executive Forum 2007

Foreword

Thank you for your interest in the PricewaterhouseCoopers[1] Basel Executive Forum, which took place on Tuesday 26 June at the London Capital Club.

We had excellent attendance from a wide cross-section of banks with a high number of international firms. As promised, we have produced the attached summary of the key messages raised during the roundtable discussions.

The main points of interest that emerged were as follows:

- In terms of meeting the FSA's expectations for Internal Capital Adequacy Assessment Process (ICAAP) and its links to ARROW, the need for senior management engagement was acknowledged strongly. Firms also discussed the challenges they are facing in addressing risk appetite. It is also clear that there is a need for more dialogue between firms and the FSA, particularly in relation to capital planning and stress testing.
- On Pillar 3, participants remain unclear on fundamental issues such as disclosure definitions and the date when disclosures will be required. The lack of clarity from regulators on definitions could, if not addressed, seriously undermine the effectiveness of market discipline. Interestingly, views were divided as to whether more prescription is desirable. Additional challenges that were debated include preparing management to discuss disclosures, educating analysts and resolving home/host issues.
- Embedding Basel II in the business remains a challenge. The key question of 'what's in it for me?' remains unanswered for much of management outside the risk community. Indeed, many firms are still unclear what benefits Basel will deliver to their organisations and how long it will take to realise them. Two areas where business benefits are already being seen are in stress testing and in improved risk information to support decisions. However, firms did not report any major impacts on pricing policy, but they do expect that changes will occur.

We plan to host future Basel Executive Forums and I look forward to welcoming you again soon.

In the meantime, if you have any questions then please contact me directly on 020 7804 6658.

Richard Barfield
Chair

1 'PricewaterhouseCoopers' refers to PricewaterhouseCoopers LLP, a limited liability partnership in the United Kingdom.

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Preparing for the SREP – what the FSA is expecting from an ICAAP and its links with ARROW

Senior management involvement in ICAAP is a top priority

A firm's score from the ARROW process on Governance and Oversight will be a key consideration for the FSA in arriving at Individual Capital Guidance that follows the Supervisory Review and Evaluation Process (SREP). The collective experience around the table was that the FSA seems much more interested in the underlying process, assumptions applied and senior management involvement in the ICAAP process than the detail of modelling processes. This was particularly true regarding forecasting current and projected capital requirements.

As part of meeting the use test, there was agreement on the need to focus on plausible stress events to engage senior management effectively. Otherwise, there is a risk that management will 'buy-out' rather than 'buy-in'. This can easily happen if they are asked to sign off on stress events that they see as unlikely, to the point of impossibility.

Risk appetite: focus and challenge

There was broad agreement that risk appetite is both an area of focus and an area of challenge. The focus is stimulated to a degree by the need to articulate risk appetite as an overarching part of a risk-based capital framework. The challenge for many firms is to link risk appetite with the day-to-day management of risk. This is needed to ensure that, as well as providing a high level expression of appetite, risk appetite is linked to tangible mechanisms for ensuring risk is managed within acceptable limits.

The roundtable discussed, in particular, the need for executives, outside the risk discipline, to be familiar with the concept of risk appetite. This specifically involved the need for them to understand the totality of the risk universe and agreed limits, and methods or paths of escalation.

FSA and firm risk appetites differ

Risk appetite is an area on which the FSA does not give specific guidance or communicate detailed expectations to firms. However, the FSA does express its own appetite for solvency risk (for all firms) as being similar to that of a BBB-rated firm. Although the FSA does not express a related confidence level, the Basel II formulae use a figure of 99.9% over a one-year holding period for credit and operational risk.

For most firms there is a disconnection between Pillar I risk profile and the internally determined risk profile due to differences between regulatory and internal methods. This is particularly the case for firms adopting standardised credit and market risk approaches, which find a significant disconnect between the highly conservative Pillar 1 capital and their own internal capital assessment. The difference needs to be explained clearly (to the extent that it is possible to do so) to reduce the risk of unnecessarily high Individual Capital Guidance (ICG).

There was a discussion on the importance for management to demonstrate to the FSA, shareholders and wider stakeholders, its ability to manage the business under testing circumstances. This would be particularly important for managing reputation risk (capital was agreed to be an inappropriate mitigant for reputation risk).

Capital planning – is it worth it?

The roundtable disagreed on the value that a three- to five-year capital plan brings to a bank. One participant shared the fact that senior management had decided not to prepare a three-year plan unless the FSA insisted on it. This was for the simple reason that the business is managed over much shorter time horizons in rapidly changing markets where innovation is constant. This means management focuses on a shorter time horizon for planning purposes – much nearer to a year or 18 months.

Another participant disagreed and pointed out that three-year planning is an integral part of the firm's management process. Intriguingly, both firms have similar risk profiles.

The table discussed the distinction between capital required and access to liquidity. It was agreed that if bailout funding can be provided by, say, Group this could lower the capital holding requirement. Nevertheless, it is necessary for management to demonstrate a formal arrangement for capital injection and a track record of demonstrable group support (one participant obtains an annual letter of comfort from the group to the FSA).

FSA stress testing expectations are not yet clear

None of the roundtable participants reported that they had yet received any clear guidance from their relationship managers at the FSA on the subject of stress testing requirements. One participant quoted a US Supreme Court justice on the subject, stating that the view appeared to be, '…we don't know how to define it, but we will know if it's right when we see it'.

The participants said that the FSA's distinction between Pillar 1 and Pillar 2 for stress testing remains unclear as do its intentions for holistic stress testing. One participant described using an approach that applies stress scenarios directly to the balance sheet and the income statement (incorporating correlations between risk types) in order to provide a holistic view of the impacts.

It was noted that stress tests should be applied to the Capital Resources Requirements (CRR), even where internal assessments produce numbers lower than the CRR. This is because a firm must be able to show that, notwithstanding its internal assessment, it will not breach its CRR over the planning horizon. One participant observed that in practical terms this may mean holding sufficient capital for Pillar 2 risks as well.

Improved risk decisions as a result of Basel II

Ending on a positive note, the table reflected on a couple of important broad beneficial outcomes from Basel II. First, banks have been forced to invest in a better data environment. Second, they have strengthened their decision-making processes for risk. In the participants' view this should lead to a better controlled operating environment. In turn, this should have an influence on ARROW assessments. It was, however, recognised that these improvements are likely to take time to embed.

External scrutiny – Pillar 3 and external reporting

Disclosures are unlikely to be comparable

Market discipline depends on comparability of data. However, the roundtable was concerned that firms are likely to interpret the disclosure requirements differently and will also choose differently between accounting and risk sources for the quantitative data. The roundtable agreed that it is unlikely that disclosures will be comparable as between firms. This could be a major problem: if this issue remains unresolved (as looks likely) it will weaken significantly the impact of Pillar 3 as a source of market discipline.

In any event, firms recognise the need to explain clearly the basis for disclosures. Interestingly, there seemed to be little appetite for disclosing economic capital data alongside Pillar 1 data. However, the roundtable agreed that, at a minimum, qualitative explanation of the differences between economic and regulatory capital will be needed.

A common view was that Pillar 3 is more about demonstrating that a firm has enough available capital, rather than providing meaningful risk data. This, of course, begs a question!

Some disclosures are not helpful

Some of the proposed disclosures are viewed as less than helpful. One participant questioned the relevance of disclosure of exposure pre-netting and pre-collateral offset. Another noted that Pillar 3 requires disclosure of securitisations in the banking book, rather than securitisation exposure in the firm as a whole – which is the broader risk. Firms were undecided at this stage about the extent of Pillar 2 disclosures.

The jury is still out on the extent of reconciliation and explanation of differences in datasets to be included in the disclosures for Pillar 1 risks. In fact, there did not appear to be much appetite (perhaps due to limited consideration) for changing financial statement disclosures to bring them more into line with Pillar 3. For example, it may be necessary to address the issue that financial statements often provide detailed analysis of loans while Pillar 3 is based more broadly on exposures.

Disclosure of the performance of credit models is seen as somewhat sensitive. It may raise issues concerning the efficiency of capital usage, where models overestimate losses (likely given the conservatism FSA has built into the application of the rules), as well as exposing underestimates should they occur.

Definitions: flexibility or prescription?

A major issue is the lack of precision of some of the requirements (and hence doubt over interpretation) and of some terms (example, exposures and value adjustments). This is one reason that firms have to make choices in many elements of the quantitative disclosures.

The FSA is seen as relatively flexible in its approach to Pillar 3, compared to other regulators. This was contrasted

with the more directive view of some continental European and Far Eastern banking supervisors. For example, one participant noted that southern European country supervisors were in favour of more prescriptive requirements covering, for example, format of presentation, location of disclosure and verification. To date, the FSA has not provided any guidance or clarification concerning definitions or interpretations of the requirements. Some view this as a criticism, but others are content with the level of prescription.

By contrast, the FSA appears to show little appreciation of the substantial data and management reporting implications of making late changes to the FSA's Integrated Regulatory Reporting (IRR) requirements. The complexity of piping in changes to reporting in a large bank is usually significant and often requires the skills of stretched IT resources.

Timing and location

Currently, the FSA expects firms to make Pillar 3 disclosures during the calendar year 2008 (or during 2007 for firms who adopt the Basel II rules in 2007). However, one observer noted that at a recent (June 2007) conference, an FSA speaker indicated that if the FSA received enough pushback from the industry that it may reconsider the date. Some firms are planning their first Pillar 3 disclosures in August/September 2008, based on their 30th June position.

Websites

While final decisions on location have yet to be made it is thought that most firms will make Pillar 3 disclosures on their website. Financial statements are viewed by some as too long already. Arguably there is some merit in keeping separate both financial statement disclosure and Pillar 3 disclosure.

Multidisciplinary teams are sourcing the data

Pillar 3 projects are typically resourced from risk, finance and investor relations functions, but many firms have yet to decide who ultimately owns the data and takes responsibility for it. As with Pillar 2, Pillar 3 seems to be breaking down the barriers between risk and finance.

The main focus is on sourcing the quantitative data needed to comply, since there are substantial lead times involved. In contrast, qualitative disclosures are seen as comparatively quick to source, either preparing from scratch or by adapting disclosures made for other purposes, for example financial statements or 20-F. Unsurprisingly, verification and validation were seen as a role for internal audit.

Is senior management ready?

There are major risks in disclosing data that senior management does not understand. This could be an important issue as a significant proportion of Pillar 3 disclosures are not used internally for risk management. Therefore management has yet to develop a 'feel' for the numbers. The problem is exacerbated by unresolved uncertainty over what is required to be disclosed.

The participants agreed that education of senior management should be a component of all Pillar 3 projects. Some firms have already prepared mock-ups of disclosures as a means of engaging senior management. Even with management education, disclosures may well give rise to unexpected or difficult questions being raised by analysts or others either in relation to a firms own disclosure or in comparison with peers.

Are the analysts ready?

Even if well presented, there is some concern that Pillar 3 disclosures will confuse analysts, due to issues of complexity and comparability – a view corroborated by analysts' notes that demonstrate limited understanding of Pillar 1. The roundtable agreed that there is a significant market education dimension to Pillar 3. There is also a real risk to share prices if the data is not well understood.

Some buy-side analysts who have tried to use financial statements to obtain better, more detailed understanding of credit risk are said to be looking forward to the prospect of more useful credit risk disclosure.

The conclusion was that Pillar 3 disclosures will require careful presentation with a corresponding need 'to tell a coherent story'.

Home host issues on disclosure

Home and host issues arise on disclosure as they do in other fields of regulation.

For non-EU groups with UK subgroups there is potential relief from Pillar 3 disclosure relating to their UK subgroup where 'comparable' disclosures are made on a consolidated basis by the parent. Some firms may submit waiver applications to FSA soon, to maximise preparation time in the event that their applications are turned down. In some jurisdictions, for example Australia and Hong Kong, supervisors are proposing to offer no such exemption, resulting in the need for disclosures by foreign-owned entities. This is prompting some firms to re-evaluate legal entity structures with a view to simplifying them.

The group disclosures that some US firms have agreed with the SEC fall well short of the level of disclosure required by the CRD. It remains to be seen how the FSA will respond to waiver applications from US groups concerning their UK subgroups.

Embedding Basel II into the business

What's in it for me?

From the discussion on this topic it became apparent that the value of Basel II is still questioned by many in business management. Many were reported to see Basel II in a negative light. The question of 'what's in it for me?' from a business or commercial management perspective – critical to embedding any major change in a business – remains unanswered for many.

Although the answer might seem straightforward and positive in a mortgage lending bank, enjoying a reduced regulatory capital charge, the perspective from trading businesses was quite different. Risk management functions in these firms can find it difficult to demonstrate anything other than compliance benefits from a Basel II programme. In these circumstances the front office becomes resigned to the cost of compliance and accepts it as a cost of doing business and as part of the required licence to operate. A further issue taxing trading businesses is, in their eyes, the questionable value of calculating operational risk and credit risk capital – the latter particularly in collateralised portfolios. As one participant observed, 'Market risk is intuitive, but traders are not worried about operational risk, while credit risk is seen as someone else's problem!' This may change due to concerns about collateralised debt obligations (CDOs).

One area where a significant reduction in regulatory capital may be achieved is in the area of market risk. Certainly for any investment bank without a CAD2 waiver, the topic is likely to be addressed now.

Investment and retail banking: poles apart on Basel II

There is a marked difference between the approach that retail and investment banks with substantial trading businesses are adopting for ICAAP and, in particular,

meeting the use test. One area of change for retail banks is capital planning and budgeting. For some retail banks there are signs that risk management's involvement in the business planning process is changing, with the risk team engaging sooner in the process as stress testing becomes a requirement for budgeting and long-term planning. Longer term planning over, say three to five years, is seen by some banks as less relevant for trading businesses where it can be viewed as nothing more than a compliance point. The industry's current interpretation of the FSA's position on Pillar 2 (that the FSA requires that a three- to five-year view applies for all businesses) is in turn contributing to a perception that the FSA may be struggling to apply a principles-based approach coherently across markedly different businesses.

No major impacts on pricing policy

The consensus view was that, to date, there is limited evidence that pricing is being affected by Basel II. The risk-based price is seen as a reference point for the commercial price, which still relies on industry comparisons, rather than being the key driver. An interesting question that was raised was 'To what extent are commercial prices influenced by sophisticated risk pricing models in some firms?' However, participants expressed concerns that the reduction of capital requirements to support certain portfolios may result in more aggressive underwriting practices to grow market share, and therefore lead to deteriorations in margins. This concern related mainly to retail portfolios and especially secured lending. Perhaps Basel will lead to cheaper banking for some customers.

The roundtable noted that pricing strategy is a complex area and would be very surprised if a bank took a mechanistic approach to price-setting, based on the required return on risk-based capital.

At this stage, none of the roundtable participants had changed their pricing policies fundamentally as a result of Basel II.

High opportunity cost of Basel programmes

A key concern is the potentially high opportunity cost of the focus on meeting Basel II compliance. Projects with a Basel II or regulatory 'badge' are being implemented and funded at the cost of projects that would be more beneficial to the institution from a risk management perspective. As observed by one member of a global financial institution, 'Basel II compliance projects resulted in an inadequate prioritisation of resources from a business best practices perspective due to the regulatory deadlines'. This, in turn, means that projects aimed to embed better risk and capital management may take a back seat compared to those that achieve compliance. An understandable view was that compliance is the hygiene factor that then permits these other activities to take place.

Stress testing delivering benefits

On a more positive note, enhanced stress testing has been seen to improve the discussion with, and engagement of, senior management and the business. The aspiration is that this involvement can be extended to a more significant role in strategic business discussions. As pointed out by a member of a prominent UK bank, 'The stress scenarios exercise promoted a lively and productive debate between senior management and business heads with regard to the impact on our business from unexpected market events, and the need to consider mitigating actions well in advance.'

Pillar 3 to the rescue?

The roundtable debated whether the reluctance of the business to embed risk management might diminish if external influences, such as investor requirements for more information on risk, have an impact and analysts latch on to the importance of strong risk management. As Pillar 3 encourages more visibility around risk, more organisations might be put under pressure to explain how they manage risk.

Others argued that the first step is for risk managers (and other managers) to make the value apparent to the business. One challenge to consider is 'Will investors be happy to regard an investment of around £100m in Basel II made by a large international bank, as a sunk cost?'

With this the discussion came full circle to the fundamental question: 'what's in it for me?'

Publications

Selected relevant publications:

Creating value: effective risk management in financial services

Getting the most out of your Basel II efforts

Risk appetite – How hungry are you?

Pillar 2 and ICAAP services

The Journal, a Global Banking and Capital Markets publication

Risk Management Conference 2006 Highlights

Global Private Banking/Wealth Management Survey: Unprecedented opportunities, plan your approach

For further information, please speak with your usual contact at PricewaterhouseCoopers or visit our website at **www.pwc.com/basel**

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