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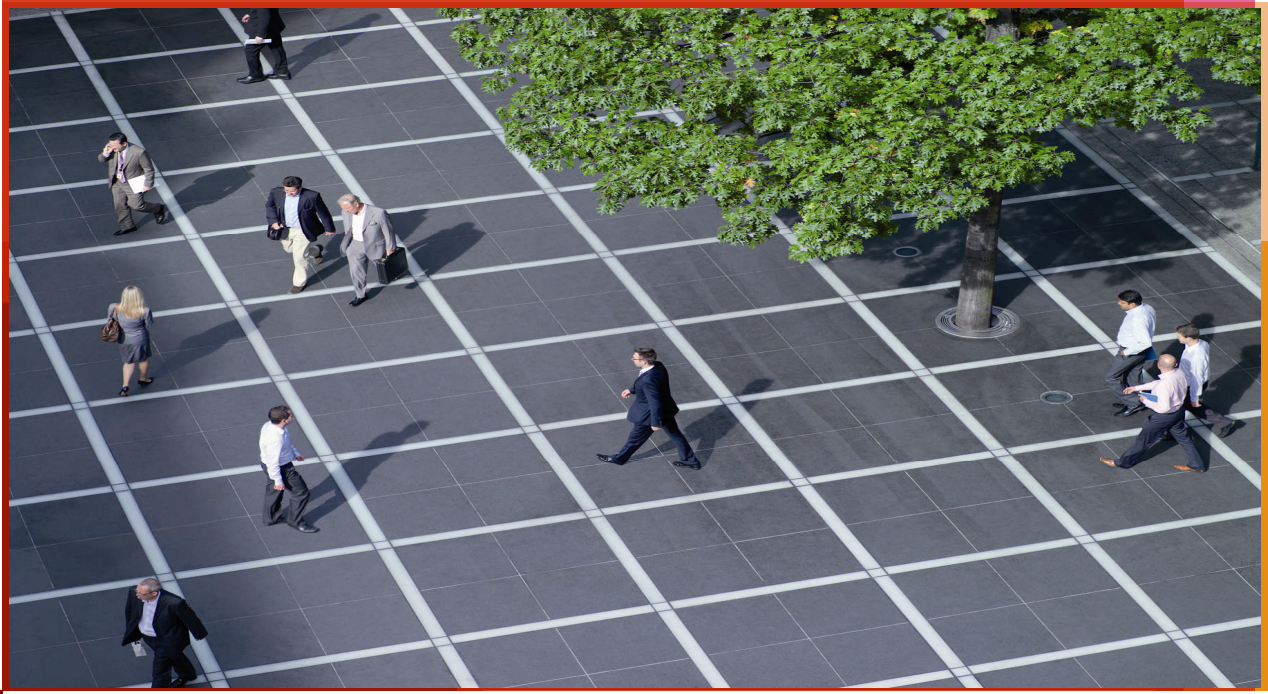
Risk & Capital Management under Basel III

London, 15 February 2011



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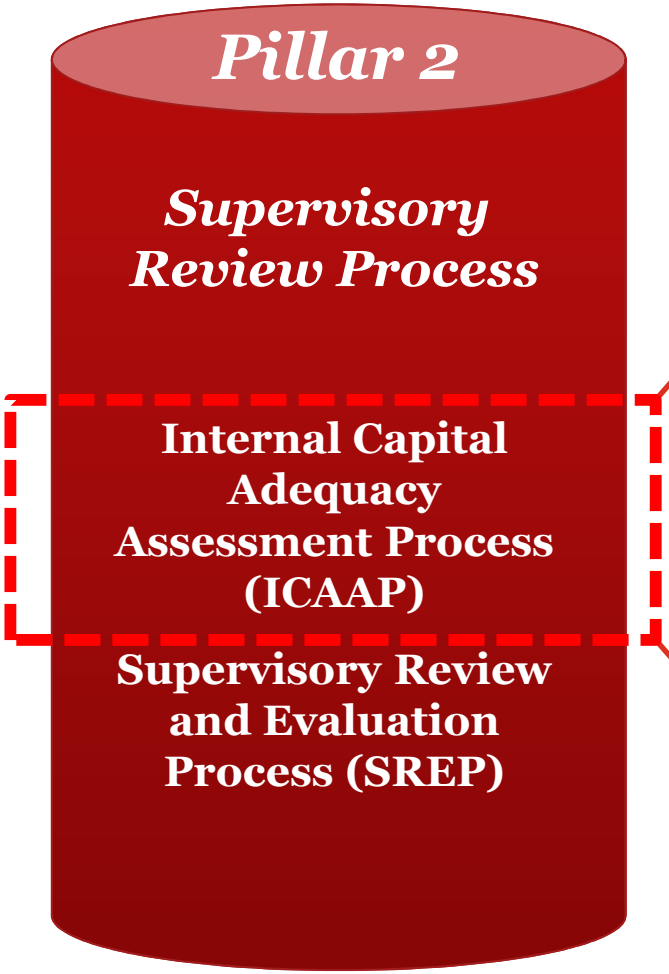
Agenda

- The ICAAP under Basel III
- Challenges for capital management
- Interaction of Risk & Finance
- Conclusions

ICAAP – Impacted by Basel III?



Components of ICAAP

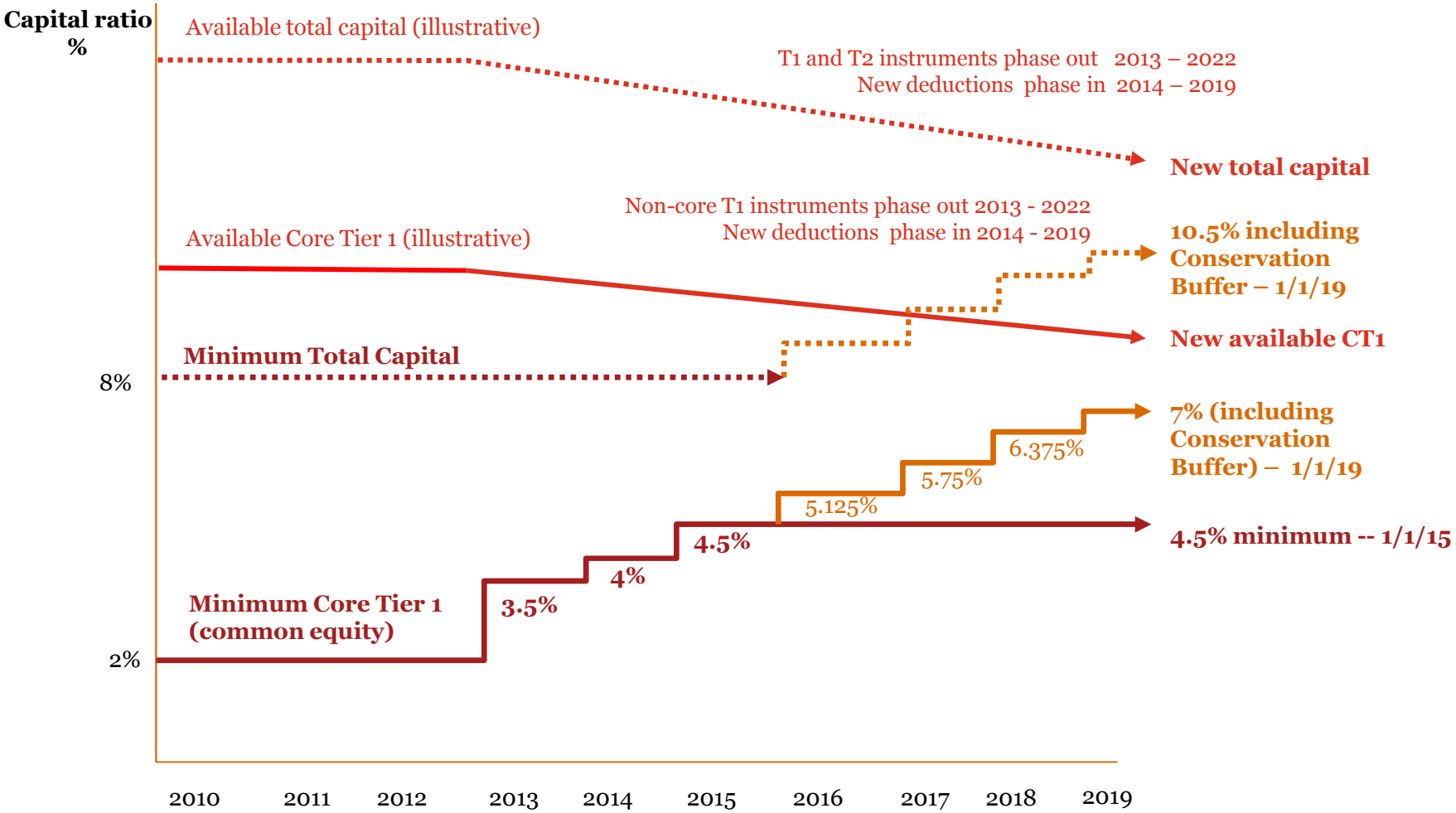
- ✗ Governance over the ICAAP
- ✗ Risk assessment
- ✓ Internal capital assessment
- ✓ Risk strategy
- ✓ Capital planning
- ✓ Stress testing
- ✗ Use test

ICAAP – Impacted by Basel III?

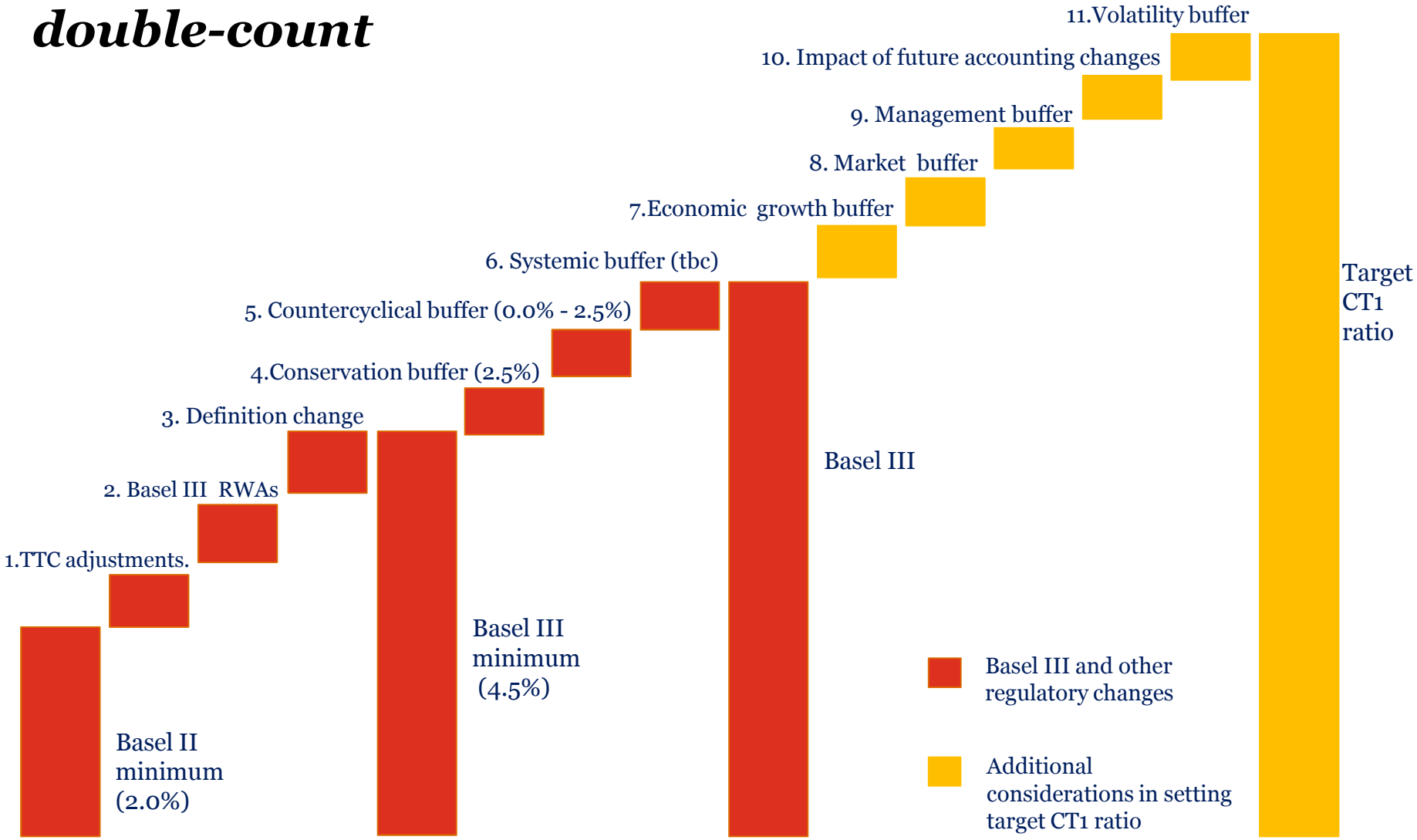
Capital planning

- Conservation buffer
- Uncertainty on countercyclical buffer
- Transition period to 2019: lengthening the capital planning period

Basel III – putting the squeeze on capital



The approach to buffers is complex and can double-count



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Four main themes will dominate bank capital management practices going forward.

1. Capital **Optimization and Mitigation** will be critical to reset business models and become integral part of decision making – e.g. strategic planning & budgeting, new business, and performance evaluation.

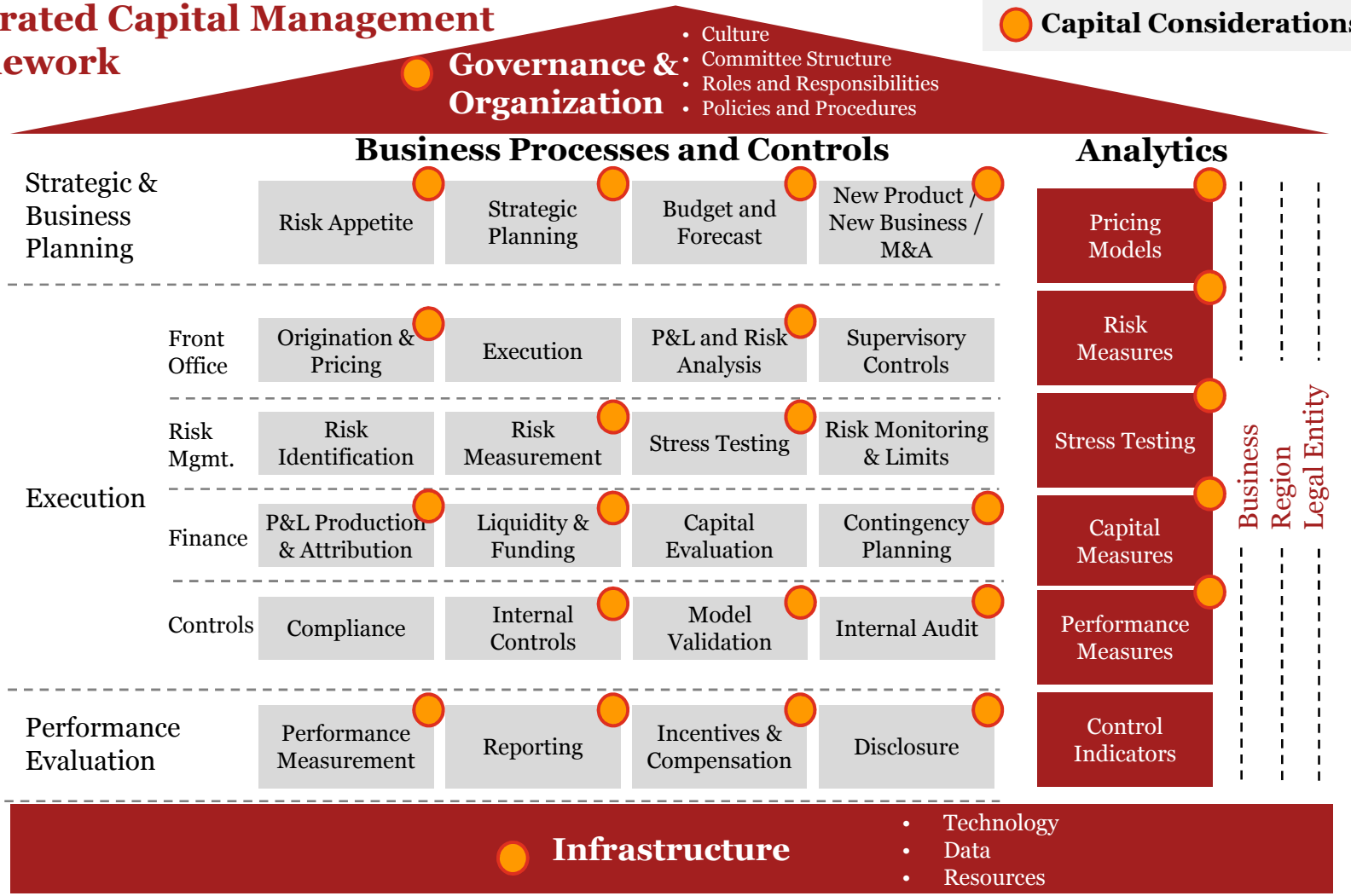
2. Capital **Structures** will emphasize high quality equity, discourage hybrids, and allow for entrance of new instruments such as CoCos.

3. Capital **Analytics and Measures** will rely less in statistical models and combine forward looking stress testing and risk measures with enhanced coverage.

4. Capital **Contingency Planning** will be integrated with liquidity risk management and corporate recovery / resolution planning processes.

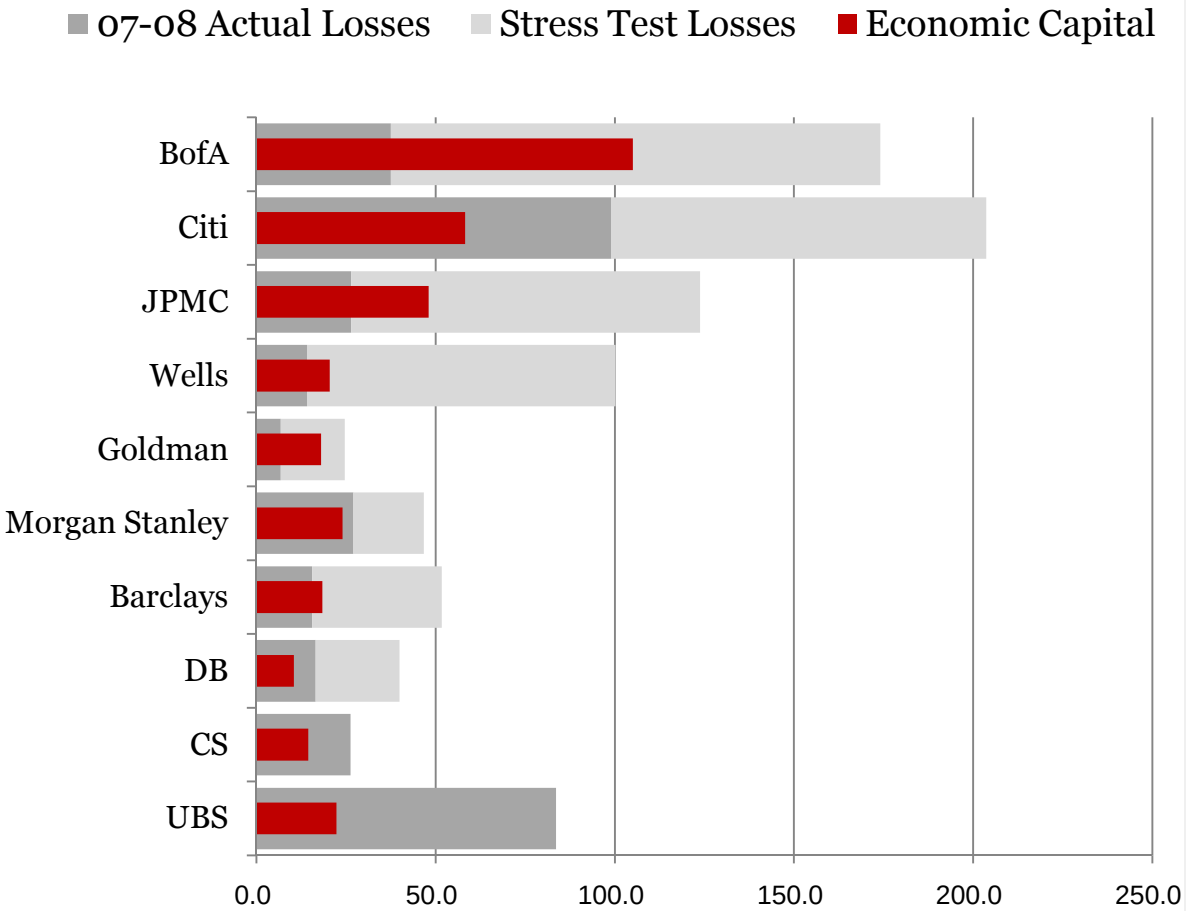
Capital is increasingly becoming an explicit component of all decision making processes.

Integrated Capital Management Framework



In the area of capital measures and analytics, more emphasis to stress testing will be placed relative to economic capital.

Comparison of Economic Capital and Actual/Stressed Losses



- Economic capital failed in most instances to capture fat tail risks
- Stress testing techniques to be combined with economic and regulatory capital measures
- Need for global stress testing practices level playing field
- Economic capital measures to converge with regulatory capital calculations

Upgrades in capital planning are necessary, including capital contingency plans that link to recovery plans and living wills

Capital Contingency Planning Overview

Key Components

Capital Measures
- Regulatory
- GAAP
- Economic Capital

Assessment Scenarios
- Forecast under specific current forecast (base case)
- Forecast under stressed scenarios (unexpected events)

Early Warning Triggers
- Market Perception
- Capital Change
- Liquidity Impact

Capital Crisis Level
Level 1 – Normal
Level 1B – Normal with Heightened Capital Concerns
Level 2A – No Crisis but Potential for Crisis Above Normal
Level 2B – No Crisis but Potential for Crisis is More Probable
Level 3 – Capital Crisis That Should not Threaten the Bank's Survival
Level 4 – Capital Crisis That May Threaten the Bank's Survival

Capital Response Actions
- Increase Available Capital
- Reduce Required Capital
- No Actions

Key Considerations
- Response Time & Operational Readiness
- Magnitude
- Type of Capital
- Stakeholder Reaction

Mobilizing Plan
- Testing & Communication
- Monitoring & Activation

Key Processes

1. Perform Periodic Assessment → **2. Determine Capital Crisis Level** → **3. Select and Implement Capital Response Actions**

Enterprise-wide initiatives like recovery and resolution planning emphasize the need for integrating capital and liquidity contingency planning

Capital Contingency Plan

- Capital measures
- Early warning triggers
- Specific stress scenarios
- Crisis levels
- Capital response actions
- Communication and escalation

Liquidity Contingency Plan

- Liquidity measures
- Early warning triggers
- Specific stress scenarios
- Crisis levels
- Funding response actions
- Communication and escalation

Integration of Capital and Liquidity Contingency Planning

Inputs, results, and actions

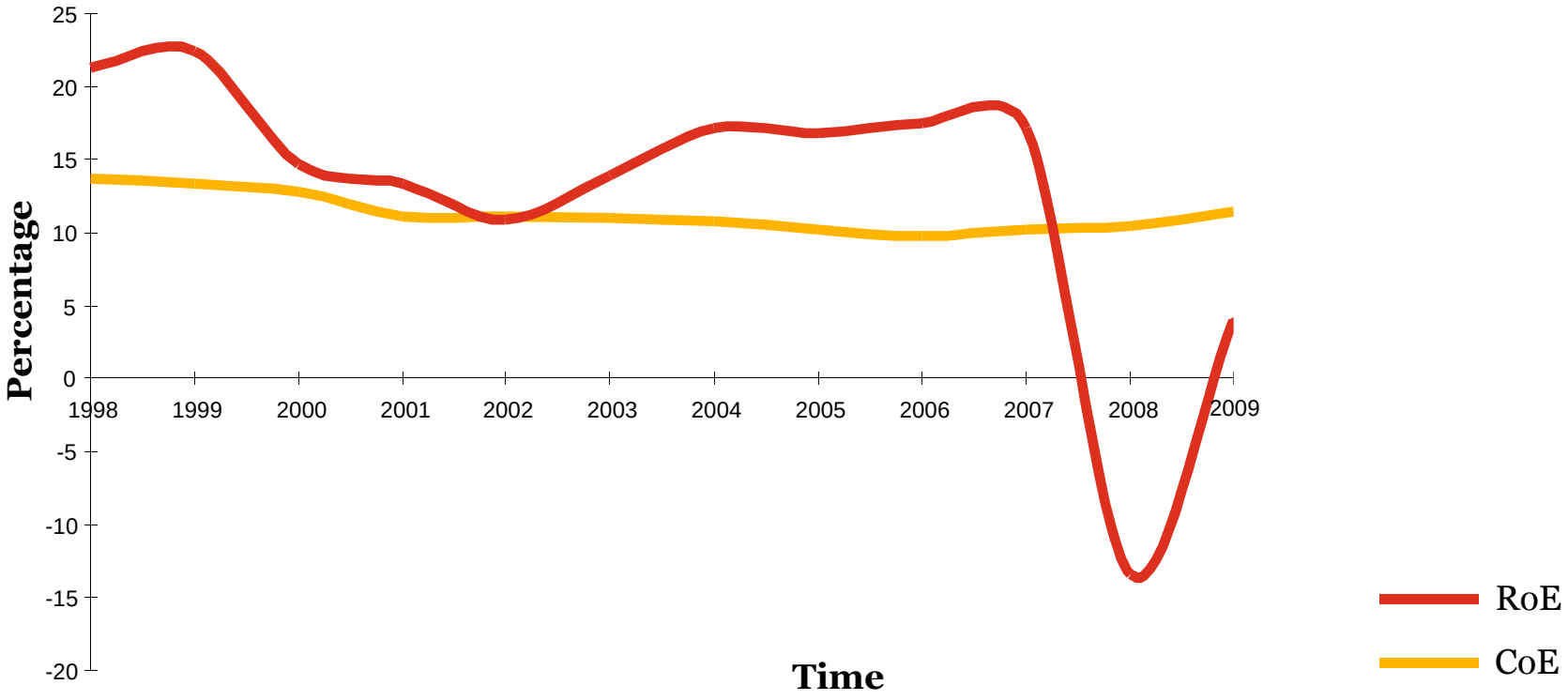
- Common early warning triggers
- Impact of liquidity specific stress test results on capital position and vice versa
- Impact of liquidity response actions on capital position and vice versa

Enterprise-wide applications

- Enterprise-wide stress testing
- Recovery and resolution plans
- Dividends and other earning retention/ distribution decisions
- Ongoing risk management

Bringing it all together – the overarching capital challenge

Banks: cost of equity vs. return on equity



Source: Capital IQ; PwC analysis – UK banks

Bringing it all together – the overarching capital challenge

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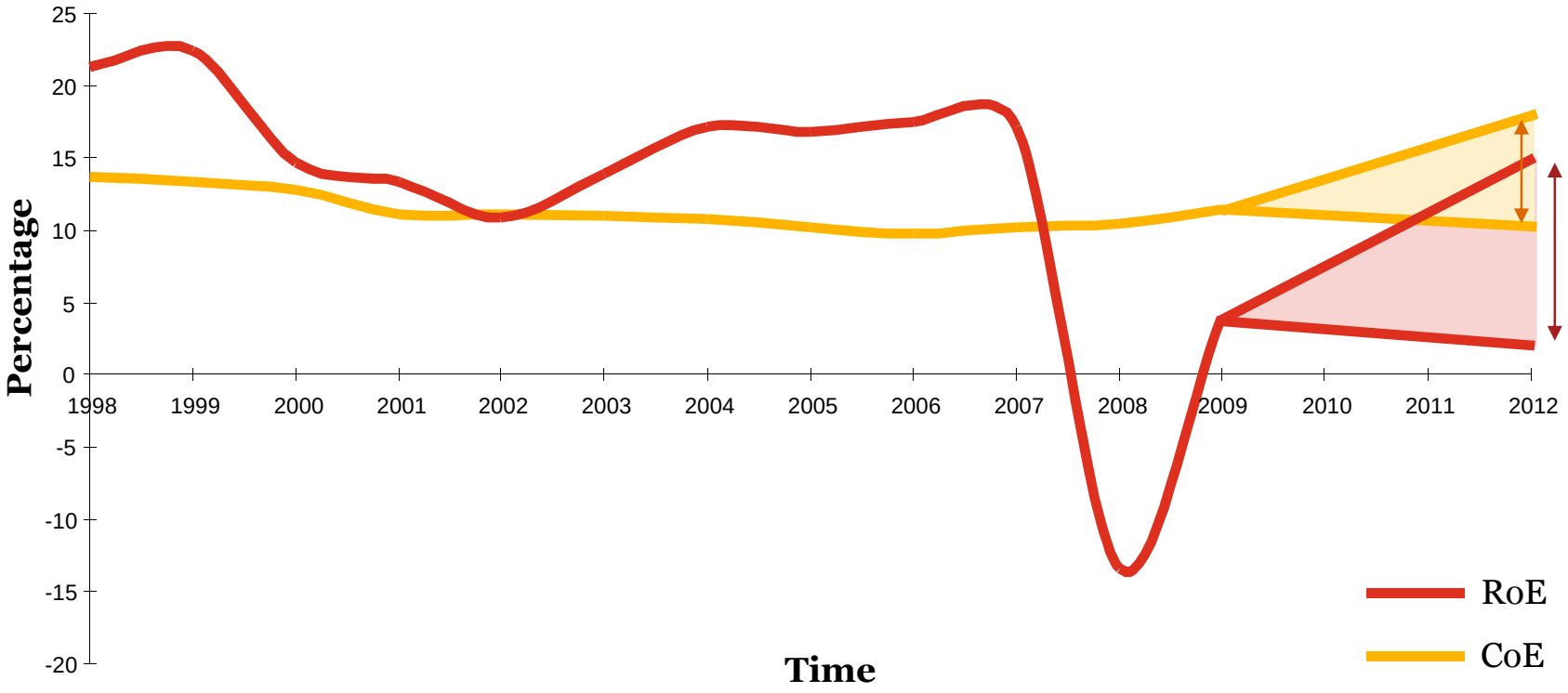

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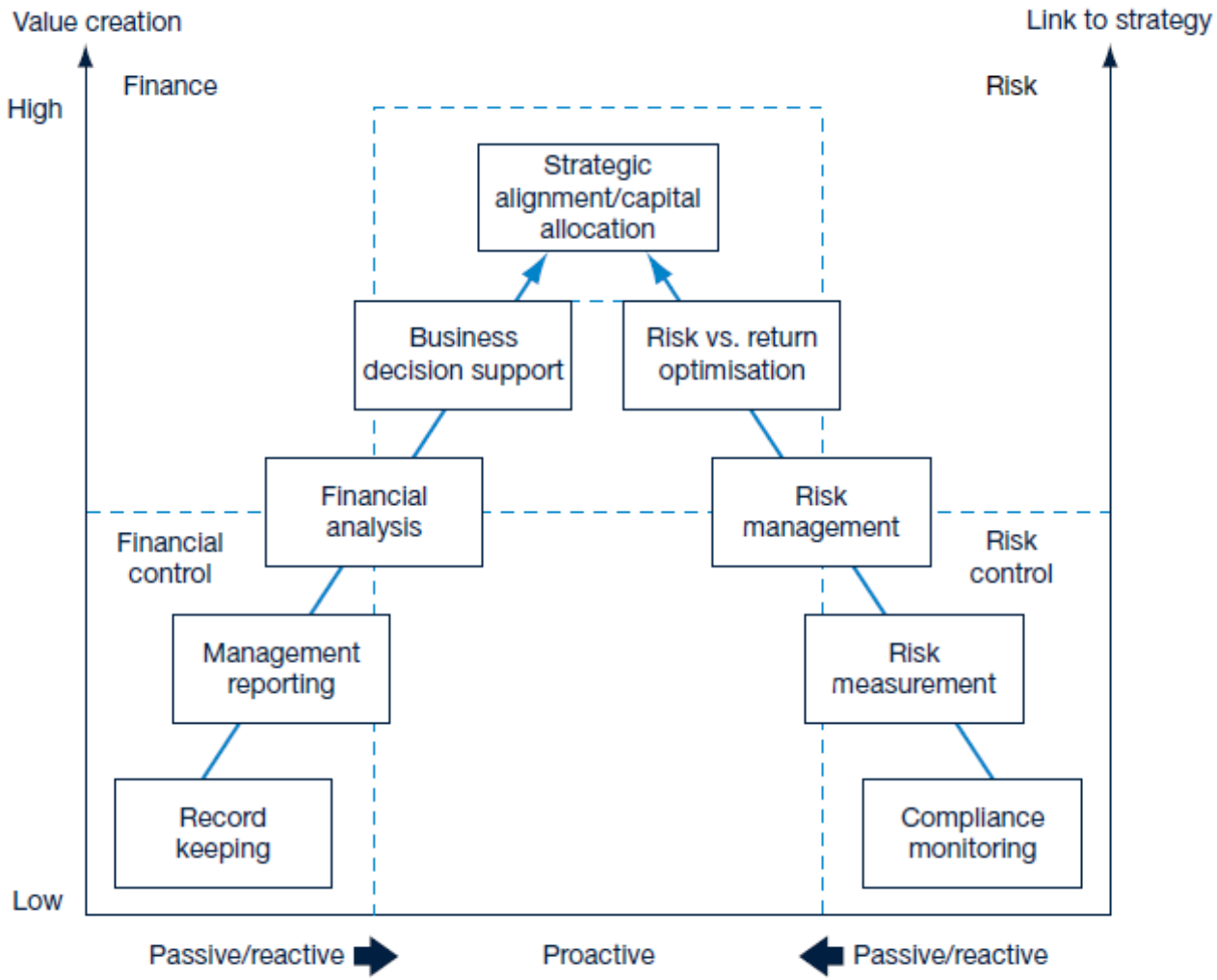
Liquidity and capital constraints force risk & finance to work together

- Management is forced to have a much sharper focus on capital and funding (and therefore risk) management
- Resource allocation decisions are top of the agenda – both in terms of capital and liquidity
- Liquidity risk function will need to get sole control over stock of liquid assets under Basel III liquidity rules
- Increased disclosure of capital and liquidity management approaches and measures to investors and other external stakeholders
- Valuation of illiquid instruments, products and collateral remains a critical issue
- CEO and Board insist on better decision support, management information and data consistency

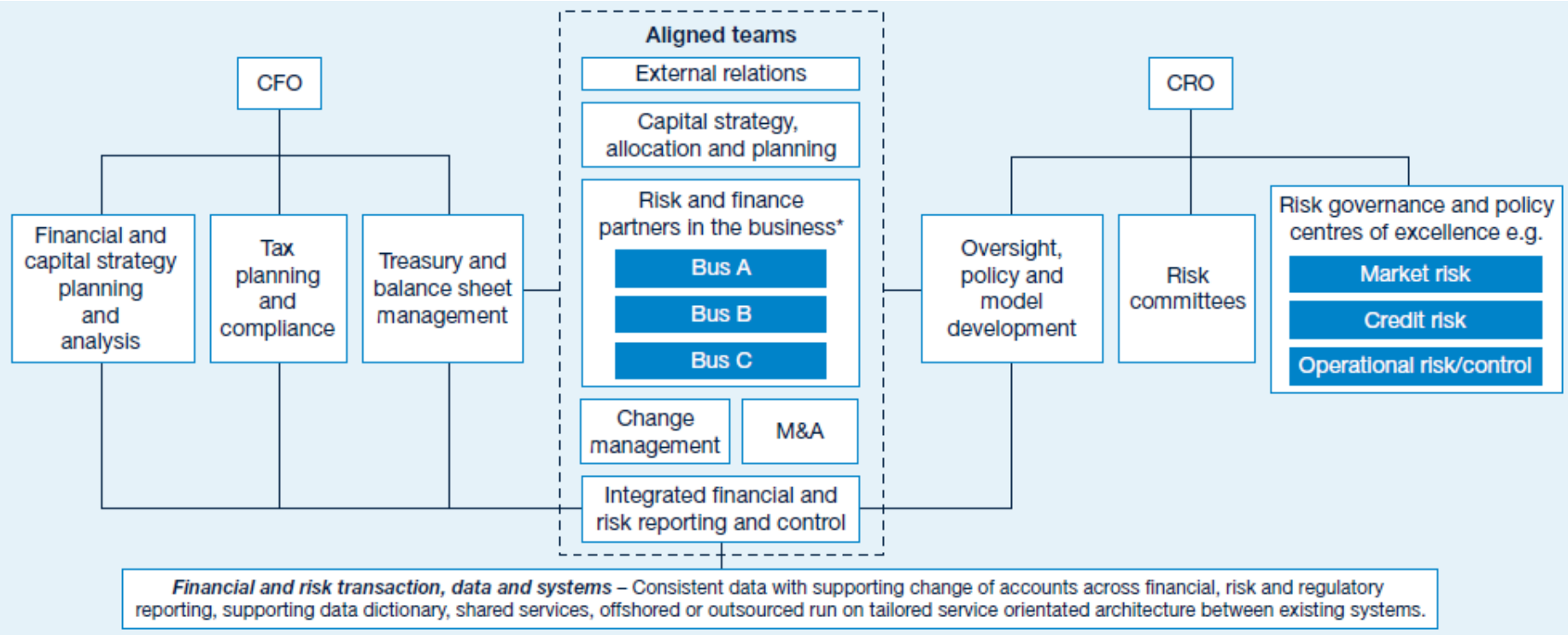
In addition, there are internal drivers pushing in the same direction …

Internal drivers	Implications for risk and finance
Strategic choices require an integrated assessment of risk perspectives	• Risk needs to be integrated at the front end of strategy and business planning processes. • Risk appetite needs to be formulated clearly, communicated and monitored • Economic capital and risk-adjusted performance measurement are no longer optional extras
Performance challenges require improved operational efficiency	• Increased appetite for simplified, integrated IT and data platforms • Finance and transactional activities increasingly standardised and off-shored or outsourced • Assessment of opportunities to apply similar approaches to risk activities
Attracting and retaining talent	• CROs and CFOs both seen as leaders with seats at the top table • Organisation models that provide challenging career paths across risk and finance • Well-defined, proactive commercial roles for risk and finance personnel, partnering with middle and front office colleagues

Linking risk & finance



Aligned risk & finance structure



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Capital management is an integral process, touching a number of organisational functions

- Risk appetite is set by the Board and cascaded through the organisation through limits, etc.
- Risk measurement is undertaken by the respective risk functions and reported to decision makers
- Finance produces planning and budgeting figures, which have to be supplemented with the relevant risk estimates
- Stress tests applied to forecasts are a joint endeavour of business lines, risk and financial planning
- Management (committees) decide on actions to be taken as a result of forecasts
- Execution of capital management actions is the responsibility of Treasury