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Securing the payback: Learning from Basel II

ROBERT VAN DER EIJK AND RICHARD SMITH

In the first edition of *Countdown to Solvency II* we examined what the experience of Basel II reveals about the scale and nature of the comparable implementation challenge for Solvency II. In this article, Robert van der Eijk and Richard Smith look at how the experience of Basel II underlines the need for a strategic approach to implementation marked by board-level sponsorship, co-ordinated planning and early organisational engagement. This can not only ease the cost and burden of the project, but also help companies to realise the benefits of their investment.



Banks are now taking stock of what for many has been a costly, gruelling and often operationally disruptive marathon of implementing Basel II. With the benefit of hindsight, some might wonder whether the process could have been easier and more cost-effective. In our experience, avoidable delays, mishaps and poor direction of resources could have increased the Basel II project expenses by up to 25% for many institutions.

Many banks have also found it difficult to secure the anticipated return on their investment in more sophisticated risk and capital management. This includes the smarter capital allocation and potential regulatory capital savings that could prove critical at a time when market conditions are tightening the squeeze on available capital. It also includes the development of a more informed and assured basis for risk communication, decision making and strategic execution, the importance of which has been highlighted by the recent turmoil in the credit markets.

As we highlighted in 'Scale of the task: Learning the lessons of Basel II', an article in the first edition of this publication (www.pwc.com/solvencyII), the technical, organisational and strategic challenges of implementing Basel II and Solvency II are closely related. Both frameworks seek to bring capital requirements into line with the risk profile of the business, with the assessment of risks and the associated capital charges placing huge demands on data collation, analytical systems and the people running them. Within both frameworks, the mechanics of risk and capital management also need to be

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underpinned by a formalised framework of governance, operational control and documentary verification that is embedded into decision making at all levels of the organisation.

Right from the start

Many insurers recognise that learning the lessons of Basel II could help them to implement Solvency II more efficiently, while reaping the potential benefits more quickly and effectively. At present, however, it is often the financial services groups that combine banking and insurance whose preparations are most firmly on track, having gained valuable first-hand experience of what the data, people and organisational requirements of Basel II entail. In contrast, while many insurers have begun tentative preparations, the focus is still primarily the technical aspects of risk-based capital evaluation, with expertise and responsibility tending to rest with back office teams scattered around the organisation.

A lack of overall direction can lead to duplication of effort. Many banks that regarded implementation as primarily a technical compliance challenge and therefore failed to mobilise their board and business teams early enough also found themselves facing a needlessly costly last-minute dash for compliance. As the deadline loomed, implementation often came to rely on an array of expensive external contractors. Bringing boards and business teams into the project late in the day also made it harder to generate the necessary understanding and embedding to meet the 'use test', while diverting valuable time and resources from other equally pressing priorities. Moreover, it meant that many institutions missed opportunities to build their new capital management capabilities into the fabric of the business and prepare strategically for the new regime.

Getting it right from the start also means developing realistic expectations about what can be achieved and how. The foundation is a thorough mapping of processes, systems, application methodologies and lines of responsibility and accountability from around the company to determine any deficiencies and discern what may be desirable and possible. This analysis can then inform a cost-benefit evaluation of possible solutions. For example, it may prove more cost-effective to withdraw or divest risk and capital-intensive products and operations rather than developing sophisticated and hence expensive capital evaluation systems. This analysis can then in turn form the basis of overall project objectives and migration plans for what will need to be achieved year by year. Drawing on the process map, plans should ideally seek to leverage all the available capabilities within the organisation, integrate new and existing systems and align Solvency II with the parallel development of IFRS and, where relevant, market-consistent embedded value. The map can also form the basis of the necessary documentation and reference.

Banks that moved forward without this foundation of analysis and planning often found that it was difficult to integrate new systems into existing operations and hence to realise the benefits. For example, a number of banks invested in the development of data warehouses and sophisticated models without planning how to ensure appropriate data supply and are therefore still struggling to secure accreditation for use of an internal model. It is therefore essential that companies look at how to develop consistent firm-wide data streams. The process mapping that underscores the project plan can inform the design of the common definitions and standardised methodologies needed to develop

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consistency and help ensure that this common approach is anchored in clear documentation.

Supervisory scrutiny

It is not just insurers who will have the benefit of hindsight. The experience of Basel II has sharpened the regulatory antennae ahead of Solvency II. Key supervisory criteria are likely to include the ability of executives to challenge capital approaches and the presence of a common 'language' for risk and reward that is consistently in use across the organisation. Those falling short or simply looking to pay lip service to the new regime to secure potential regulatory capital advantages are likely to face exceptionally probing and sustained regulatory scrutiny.

Leadership from the top proved especially critical in ensuring that sufficient resources were allocated, that implementation became an organisation-wide priority and that any issues or obstacles were tackled promptly and effectively. In turn, early training, communication and engagement of the organisation helped to ensure effective collation of data and a better understanding of the implications of the new regime. This included how the Basel II criteria would affect product design, capital allocation, pricing and broader strategic choices in areas such as M&A and new market entry, with early movers able to make the necessary adjustments ahead of the regime going live.

Perhaps most of all, early engagement helped to convince frontline teams that better risk evaluation and awareness could enhance their decisions and ultimately the quality of their returns in areas such as lending, rather than seeing Basel II as an arbitrary capital charge. The

challenge for risk and capital management teams is how to turn 'black box' numbers that are geared to generating regulatory capital calculations into tangible information that can be used, understood and, not least, trusted by the business. Wherever possible, risk professionals should work with business teams to develop a better understanding of the challenges they face and the kind of information that could give them a competitive edge.

Strategic perspective

Ensuring organisation-wide engagement is equally critical in addressing the strategic dimensions of Basel II and Solvency II. Both frameworks represent a new blueprint for the way companies are run, challenging roles and responsibilities and ushering in a new approach to how risk is managed and built into decision making.

Most banks have benefited from greater transparency about risk and the capital needed to support it. However, experience to date suggests that many institutions are still finding it difficult to turn their more sophisticated analytical capabilities into a more informed and assured basis for decision making. Key challenges include embedding their risk appetite into business planning and aligning risk and financial management as part of a common language of risk and reward.

As the experience of Basel II underlines, to overcome these difficulties companies often need to break down the operational silos that demarcate risk and finance, along with the silos that separate the various components of risk. While consistent metrics and common repositories for risk and financial data are clearly helpful, this is also a challenge that demands fresh perspectives about

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strategic objectives, performance management and the wider culture of the organisation.

A recent PricewaterhouseCoopers global survey of risk management in the insurance industry indicates that many companies may have some way to go in developing this more integrated and risk-aware approach.¹ Barely a quarter of respondents strongly agree that they have an efficient basis to link risk with financial information or that their economic model has secured buy-in within the business or influence in decisions. Less than half align key strategic areas such as product development with their risk appetite.

It is equally telling that 30% of the respondents who indicate that their board relies on the risk measures produced by the economic capital model were nonetheless unable to articulate the purpose or use of this model. Such articulation is clearly critical in senior management's ability to incorporate risk-based capital evaluations into sound decision making and, where necessary, challenge the underlying assumptions. A case in point highlighted by Basel II has been the reduced levels of capital often allocated to mortgages and property-secured lending, which in many cases has failed to take into account the basis and funding risks that have been brought into sharp focus in the recent credit and liquidity crisis.

¹ A report based on the findings of PricewaterhouseCoopers' global ERM study is due to be published in summer 2008.

Evolving roles

Looking beyond management information to how the business is directed, both the PricewaterhouseCoopers risk survey and the experience of banks under Basel II would suggest that many CROs and other risk professionals are yet to play an up-front role in key decision making. For example, while they may be consulted about M&A or new products, their input is often confined to a reactive or restrictive veto rather than being brought into the process at an early stage where their advice could be more valuable.

Developing a more strategic role for the CRO is likely to require a shift in mindset. Clearly board and business teams need to see risk management as a business enabler rather than a compliance requirement. In turn, risk professionals need to be more assertive and commercially minded in bringing their influence to bear. In some companies, this may call for a shift in the make-up of risk teams, including bringing in more people with business and finance function experience. This cross-fertilisation is increasingly evident within banks following the move to Basel II. However, our risk survey would suggest that it is less so within insurance. It is important that the CRO has a portfolio view of risk and reward, along with the business sense to convey risk in a language that is understood by and is persuasive within the business. An overly technical perspective might appear remote from the priorities of boards and business teams.

For the business as a whole, there are culture and change management challenges in moving to a more systematic and formal approach to risk management. Actuaries, risk managers, finance teams and risk-takers need to work closely together. Companies should ideally align incentives and performance objectives with risk-adjusted measures to help instil

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risk awareness into the mindset of the business. Ultimately, as the recent credit turmoil highlights, CROs need the authority and credibility to challenge decisions and risk positions, while companies ensure timely communication and decisive escalation in the face of emerging risks.

Smarter risk and capital management

Solvency II is likely to require a far more sophisticated infrastructure of risk information and control within many insurers. While this is a challenge in itself, companies also need to look at how the new regime will affect the way they organise and direct their business. This includes the basis for decision making, the role of risk management within the business and how effectively risk is aligned with financial management.

However, Solvency II could also provide an opportunity to develop valuable competitive benefits including a more informed risk-adjusted basis for decision making and the targeting of limited capital where it can earn its best return. As the experience of Basel II underlines, the key to achieving this is bringing implementation plans out of the back office and into the boardroom and frontline of the business. It is also an interactive process in which the more business teams recognise the benefits, the more they have input into the

project and enhance the potential gains. While there is no one-fits-all approach to developing this business-focused programme, successful banks tended to share the following attributes:

- Programmes directed by an active executive-level sponsor;
- Early and thorough mapping of existing capabilities and future needs to form the basis of cost-benefit analysis, realistic project objectives and migration plans for year-by-year goals;
- Engagement with the organisation at the outset to develop company-wide understanding and gain widest possible input into the programme, focusing in particular on the impact and potential benefits;
- Articulation and communication of the goals, strategy and benefits;
- Preparation of a detailed project plan, setting out key milestones, clear timescales and issue resolution procedures; and
- Identification of the business challenges and opportunities and how to gain early-mover advantages over competitors.

In conclusion, tackling Solvency II as a business opportunity to enhance risk and capital management and clarify the organisational structure and business processes, rather than looking at it as a compliance headache, will help firms to deliver valuable benefits. ■