

# Introduction and Overview: Practical Implications of Basel II and CAD developments

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- A new timetable?
- Implementation issues
  - Geopolitical
  - Real world
- The Standardised Approach – Basel or EU-lite?
- Advanced Measurement Approach
- Insurance – mitigant or good management?
- Will the regulators achieve their aims?

# A new timetable?

- Q2 04 – Basel II published (was Q4 03)
- Feb 04 – EC draft Directive?*
- June 04 – European Parliament elections (new Commission; new Parliament; enlargement)*
- Sept 05 – target to complete EU process (and national legislation?)*
- 2006 – parallel running of Basels I and II
- 1 Jan 07 – Basel II and CAD implementation

# Implementation issues – the geopolitics

## US implementation

- Basel I or Basel II Advanced – the ANPR
- Investment banks and SEC

## EU implementation

- Politics
- Pillar 2

## India and China

# Implementation issues

## - the real world

### Home/host issues

- **Consistency** — of standards and approaches
- **Interpretation** - one interpretation per jurisdiction
  - lead supervision of consolidated group
- **National discretion** — reduce the numbers

### Cost, complexity and flexibility

- for firms and supervisors; resources available?
- prescriptive rules vs flexible guidance
- Basel I as transition to 2010?

# Why be Basel standardised?

CP3, para 609: “Banks are encouraged to move along the spectrum of available approaches . . .”

## Standardised Approach

- Gross income by business unit x  $\beta$  (12/18%, incl 18% for corporate finance, trading and sales, payment & settlement)
- Alternative approach – default to highest  $\beta$
- Business lines - and cost centres
- Qualifying criteria almost identical to Advanced Measurement Approach

Where’s the encouragement?

# Try EU standardised – lite

- 11 lines vs 2 pages of qualitative criteria
- Less detailed requirements for:
  - Operational risk management
  - Operational risk losses
  - Assessment and reporting
  - Validation and data
- Different audiences for Basel and EU and encourages firms to move along the spectrum, but it all adds to the complexity of implementation.

# Advanced Measurement Approach

“Unprecedented amount of flexibility” (CP3 overview para 42)

[Self-]assessment versus measurement

Range of methodologies encouraged, including scenario analysis, risk indicators

- But note quantification language – tail, distributions, 99.9% confidence; EL/UL

Data versus information

- Internal (threshold)
- External (amount, type, date, scaling, health warnings, sources)
- Operational and credit/market risk loss boundaries and ‘tracking’

Partial use

# Insurance - mitigant or good risk management?

Insurance as a capital substitute or as it is in reality?

Available for AMA only and subject to a 20% cap

## Criteria

- Single A claims paying
- Policy term; cancellation and renewal periods
- Exclusions
- Mapping to risk classes/loss event categories
- Captives
- Speed of payment – the dog that did not bark

How do you value a policy? (compare earlier EU CAD premium and limit approaches)

Business environment and external control factors

# Will the regulators achieve their aims?

Ensuring firms hold adequate capital for high-impact, unexpected events

Incentivising good risk management practices

Raising awareness of operational risk as a threat to global financial stability

Raising awareness of operational risk as a proper topic for senior management concern and involvement, c.f. Turnbull

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