

Practical implications of Basel II and CAD developments

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The latest timetable

- Q2 04 – Basel II published (was to be Q4 03)
- Q3 04 – *EC draft Directive?*
- June 04 – *European Parliament elections (new Commission; new Parliament; enlargement)*
- Sept 04 – *FSA publishes outline PSB text (final version Jan 05 ?)*
- 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 Advanced Notice of Proposed Rulemaking
- Investment banks and SEC (different definition of OR!)

EU implementation

- Chocolate, bananas and politicians
- “The BIS has no democratic mandate” – House of Representatives and Alexander Radwan, MEP
- Pillar 2

India; China (and Hong Kong); non-G10 countries

Implementation issues

- the real world

Home/host – the big issue

- Consistency – of standards and approaches, e.g. validation of AMAs; allocation of capital across groups
- Interpretation
 - one interpretation per jurisdiction
 - lead supervision of consolidated group
- National discretions – reduce them

“The FSA will try to ensure an approach broadly consistent with other Member States where appropriate . . .” (FSA ORSG Minutes 9/12/03)

Cost, complexity and flexibility

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

More implementation issues

Pillars 2 and 3 (c.f. Kyoto, IASB etc)

Regulators and capital

- Fundamentally, regulators (mis)trust each other
- Prefer capital to risk management
 - To support business as going concern
 - To protect depositors in a gone concern
- Therefore, they will keep capital at home
- Subsidiarity rather than co-operation and co-ordination

The underwhelming BIS paper on cross-border implementation (Feb 2004)

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 β (12/18%, incl 18% for corporate finance, trading and sales, payment & settlement)
- Alternative approach – default to highest β
- Business lines - and cost centres
- Qualifying criteria almost identical to Advanced Measurement Approach

Where’s the encouragement in that?

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
- Reflects different audiences for Basel and EU, and encourages firms to move along the spectrum, but it all adds to the complexity of implementation.
- But will the draft survive or move closer to Basel?

Advanced *Measurement* Approach (1)

“Unprecedented amount of flexibility” (CP3 overview para 42)
[Self-]assessment versus measurement

Basic building blocks

- Loss event data
 - But note quantification language – tail, distributions, 99.9% confidence; EL/UL
- Risk indicators
- Scorecards; (control) self-assessment
- Scenarios and stress tests

Partial use

Advanced Measurement Approach (2)

Data vs information (or ‘What’s so interesting about losses?’)

- Internal (consistent reporting, complete reporting, threshold, relation to General Ledger)
- External
 - data pools vs public data
 - apples and pears
 - integrity re amount, type, date etc; scaling
- Operational and credit/market risk loss boundaries and ‘tracking’
- Profits, near misses etc

Information vs knowledge (or ‘Measurement vs management’)

Reporting - dashboards

Insurance - mitigant or good risk management?

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

Available for AMA only (Basel and EU) and subject to a 20% cap of AMA charge

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

But how do you value a policy, let alone the risks it covers?

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