

Risk Management & Basel II - “Deriving Value Beyond Compliance”



February 24, 2011

Risk Management & Basel II - “Deriving Value Beyond Compliance”



Introduction



Key Management Considerations!!

- Is it a risk management or an organisation-wide initiative??
- Magnitude of change we should expect in our organisation
- How to create organisational buy-in and how should change management be successfully implemented??
- Areas we will need to work on to derive optimum value and ensure compliance
- What is the expected level of effort to achieve completion??
- How can we ensure effective programme management??
- Pitfalls to avoid so as to ensure maximum possible value is derived
- Capacity building and sustainability – Not a one – off or point –in – time exercise

What is the value of implementing best risk management practices and Basel II beyond compliance and how best it can be achieved??



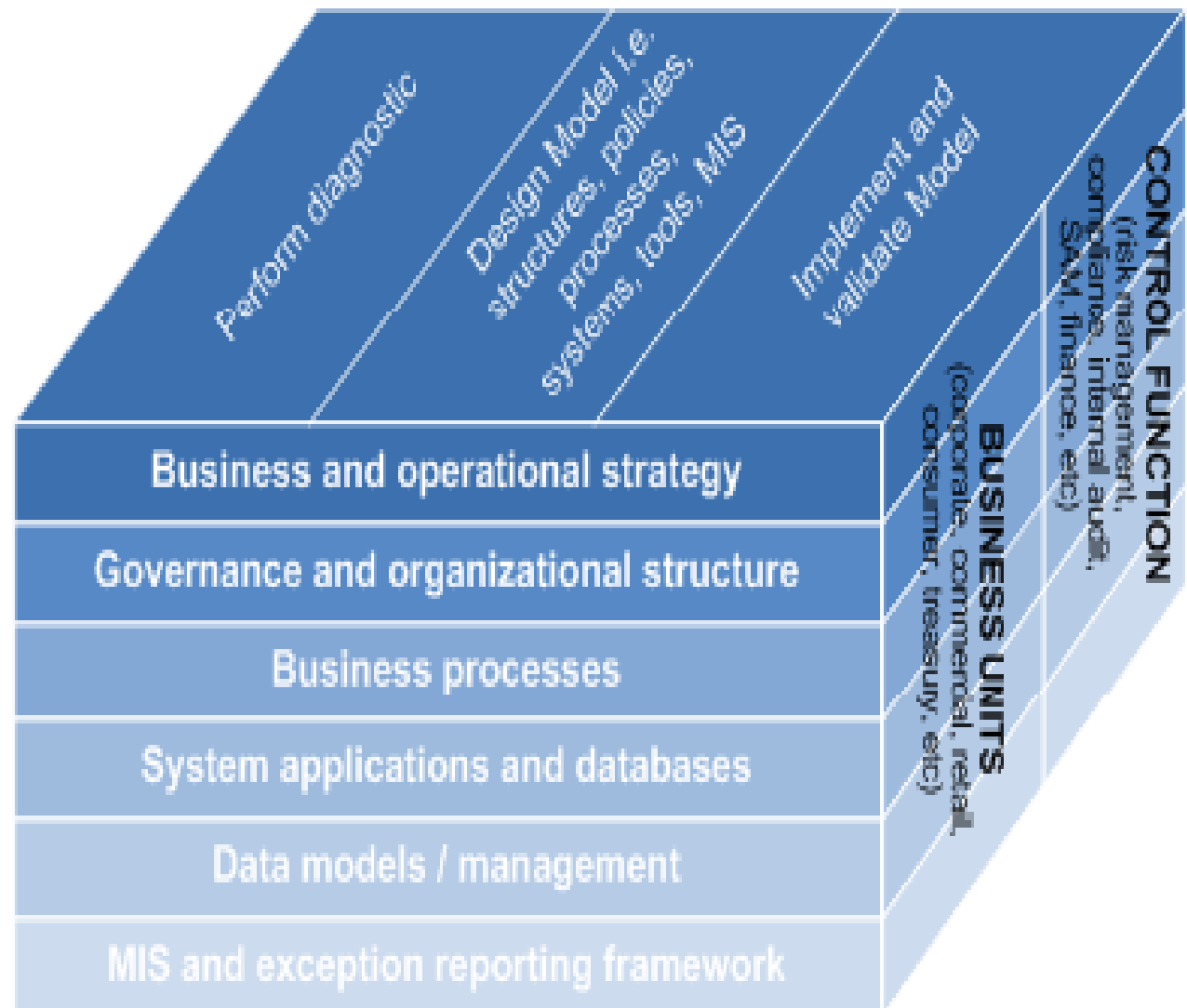
Basel II & Risk Management Significantly Impact!!

Multi- Dimensional

Spans over the entire organization

Addresses both the design and implementation objectives

Covers all areas of business and operating model





Why is Basel II Value beyond Compliance?

Basel II is a Regulatory Version of Best Practice Risk Management

- Sound tool to optimally strategize business and operations to deliver on the organizational goals and objectives
- Capital optimization better reflecting the entity's risk profile
- Better governance, structure and oversight at ALL organizational levels
- Risk oriented culture and accountabilities
- Robust IT Architecture to meet evolving business and compliance needs
- Sound data models for effective decision making
- Strong data protocols for data reliability
- Concentration on the portfolio view of risks to better integrate with overall decision making



Why is Basel II Value beyond Compliance?

Basel II is a Regulatory Version of Best Practice Risk Management

- Better credit assessments and lending decisions
- Sound NPL management and consequent loss reductions
- Operational loss reduction through focused assessments and reviews
- Control design and implementation effectiveness to better manage operational risks
- Process efficiencies across the organization
- Enhanced business monitoring capabilities from robust MIS frameworks



Snapshot of Basel II Compliance

- Most of the developed economies are already compliant with advanced approaches e.g.

<ul style="list-style-type: none">▪ Australia▪ New Zealand▪ European Union▪ Japan▪ Canada	<ul style="list-style-type: none">▪ Korea▪ Singapore▪ Hong Kong▪ Taiwan▪ Malaysia
---	---

- Other countries are transitioning or planning to transit to advanced approaches (e.g. China, India, Thailand, Philippines, Indonesia, Sri Lanka, UAE, Saudi Arabia)



Few Global and Regional Experiences

- Large Australian Bank managed to achieve sufficient differentiation in customer risk grades resulting in competitive advantage
- Operational loss reduction by approx. 28% for a Large Canadian Bank
- A Bank in Singapore was able to considerably improve consumer portfolio quality and service by implementing best practice rating tools and sound consumer finance organisation
- Significant credit turnaround time reduction in the case of a Large Regional Bank through implementation of loan origination systems and transformed CAD processes
- A New Zealand Bank - Improvement in ALM balance through implementation of ALM systems and “Management Action Plan (MAP)” programmes – resulting in improved liquidity management



Manage Change

Inculcate a change oriented culture and approach across the bank

- Readiness to accept and implement changes in the way you:
 - do strategy setting and business planning
 - are organised and/or structured
 - do risk assessment, measurement and monitoring
 - have designed your credit and portfolio management functions
 - collect, validate, control, organise and analyse the data
 - operate in terms of IT architecture and the design of various systems
 - report the risk internally and externally
- Considering the organisation wide impact, all the departments/ groups are stakeholders in the Basel II programme with some being the most critical participants - Not merely a Risk Management Project!!

Risk Management & Basel II - “Deriving Value Beyond Compliance”



Project Initiation and Planning



Diagnose ALL Areas → Identify What to Do

- Diagnose ALL aspects including:
 - Governance, organisation, data, process, MIS
- Not just Basel II, but Basel Committee Guidelines are also critical!!!

Besides provisions of SBP Basel II Framework, coverage of Basel Committee Guidelines for various risk streams is important to:

- Derive maximum value by incorporating best practices in relevant processes
- Ensure better readiness of the bank in relation to Pillar II
- Use comprehensive and multiple evaluation techniques, don't over rely on interview/ questionnaire type approaches

Experience suggests detailed reviews of policies/ procedures manuals, duly supported by data, process and system walkthroughs provide the best basis for as-is understanding



Do Detailed and Effective Planning

- Plan in detail, mere identification of remedial actions is not sufficient

Appreciating that a number of areas involve complex remedial actions, with significant interdependencies amongst departments and process, systems and organisation etc., the banks should create comprehensive remediation plans for each project describing in detail:

- Project objectives and scope
- ALL initiatives to be undertaken mapped with respective gaps such that remediation plans address ALL gaps
- Structured roadmap for implementation duly identifying responsibilities and timelines
- Project Team Structure

Risk Management & Basel II - “Deriving Value Beyond Compliance”



Key Value Drivers



Optimize Strategic Planning

Key Areas to Focus	Value added
<p>Ensure the <u>Strategic Plan</u> incorporates with the required granularity:</p> <ul style="list-style-type: none"> ▪ Target markets ▪ Portfolio mix/ diversification ▪ Capital planning and allocation ▪ Pricing and collateralization strategies ▪ Stressed projections and CAR ▪ Operational strategies 	<ul style="list-style-type: none"> ▪ Better target setting for business units and effective operational roll-out ▪ Clear strategies providing better monitoring platform for decision making ▪ Rationalized portfolio quality ▪ Effective MAPs for future capital management concerns ▪ Optimized return on capital
<p>Engage Business Units and integrate Risk Management in the exercise</p>	<ul style="list-style-type: none"> ▪ Ownership, drive and accountability ▪ Independent view on planned risk exposures and markets
<p>Integrate budgeting with strategic planning</p>	<ul style="list-style-type: none"> ▪ Integrated annualized targets help in eventual achievement of long-term goals



Improve Governance

Key Areas to Focus	Value added
<p>Enhance the scope and quality of Board and senior management oversight:</p> <ul style="list-style-type: none"> ▪ Vision and strategy setting ▪ Key risk assessment and monitoring ▪ Significant operational loss reviews ▪ Portfolio management ▪ High value credit risk reviews 	<ul style="list-style-type: none"> ▪ Better target setting for business units and effective operational roll-out ▪ Clear strategies providing better monitoring platform for decision making ▪ Rationalized portfolio quality ▪ Effective MAPs for future capital management concerns ▪ Optimized return on capital
<p>Address conflicts in the organizational structure:</p> <ul style="list-style-type: none"> ▪ Risk Management/ Credit approval override in decisions ▪ Escalation provisions ▪ Avoid concentration of authorities 	<ul style="list-style-type: none"> ▪ Improved credit discipline and potential reduction in credit losses ▪ Better oversight and timely actions on exception cases ▪ Reduction in possibilities of operational losses, improved mitigation of fraud risk



Emphasize on IT Architecture

- For Basel II data and best practices to be in place, IT Architecture is KEY

ALL dimensions are important to derive maximum business and risk value:

IT Architecture addresses all automation needs	Identify all system needs upfront and plan accordingly
Relevant systems provide required data fields, features, controls, MIS	Create detailed To-Be functional specifications
System integration is in place and systematic application, data and process flows are available	Map the processes for each system, document source points and flows, create integration maps and plans
Strategy for legacy core systems during transition period	Implement legacy system enhancements/workarounds
Select the most appropriate solutions and vendors	Conduct systematic due diligence (through organized demos and reviews) against detailed requirements
Manage project and ensure system design provides required business and risk features	Create detailed business blue prints, provide functional expertise, validate at various points



Emphasize on IT Architecture

- Establish which areas to automate/ consider:

<ul style="list-style-type: none">▪ Core banking enhancements▪ <u>Loan origination and CAD</u>▪ <u>Internal credit risk ratings</u>▪ Market risk	<ul style="list-style-type: none">▪ Capital calculation▪ Operational risk▪ Asset Liability Management▪ Portfolio management and stress testing
---	---

- Evaluate against each required data field/ functionality compared with vendors' responses to the RFP, along specified criteria
- How can we confirm RFP responses???

The accuracy of vendors' representations in RFP is validated by participating in detailed systems demonstrations by the vendors. This is key as variances are usually identified from original responses while reviewing system performance during demos.



Emphasize on IT Architecture

Reaping benefits!!!

- Avoid any surprises at a later date in terms of system capacity/ capability (that usually leads to significant project overruns)
- Prevent avoidable customisations and hence optimise implementation costs
- Smooth and phased roll-out of the envisaged IT Architecture
- Eliminate data, process and system redundancies/ inefficiencies



Enhance Data Platforms and Quality

Data Management is critical!!

- What data is required, from what sources it can be available, what are existing data controls over fields and what should be
- What enhancements are required in the systems to capture the data, if manually maintained or not captured in required form or with controls
- Who will be data owners/controllers to collect and provide duly validated/cleansed data (e.g. depending on information type, branches to collect data on templates, regions/controlling offices to validate, Risk Management to collate, review, analyse and use cleansed data for development of risk tools)
- Going back in time over a reasonable period (2-3 years) to seek cleansed data for some elements (e.g. customer historical financial and non-financial data, historical operational losses such as frauds, leakage of income etc.)



Enhance Data Platforms and Quality

- Identify data requirements for ALL areas and create detailed data blue prints:
- Assess systems and platforms, create and implement action plans for enhancements
- Develop and implement data organisation, protocols/ controls for data entry, validation and reconciliation



Enhance Market Risk Environment

- Risk Measurement model helps in price trend analysis - aids in foreseeing upcoming market developments and strategize accordingly
- Portfolio segmentation based on various criteria such as price volatility, portfolio correlations etc. – helps in achieving optimum risk diversification
- Rationalised limit setting due to availability of risk vs. return data
- Proactive responses to market events through defined “Management Action Plan”
- Flexibility in analysing model results through use of human judgment – Avoids model over-fit and biased decisions



Focus on Loss Data Collection

- Operational loss data collection and management is the key cornerstone for the ORM process.
- Key Areas to Focus
 - Develop detailed loss data collection templates
 - Prescribe standard operational risk/ loss definitions
 - Assign responsibilities, reporting lines and ensure departmental coordination
 - Assign focal point for loss data collection, aggregation and reporting
 - Ensure system automates the loss data collection cycle from reporting – aggregation – consolidation – reporting



Focus on Loss Data Collection

Loss Database – Sample of Fields

- Serial No.
- Period
- Date/Period of Incident
- Date of Detection
- Date of Reporting to ORC
- Date of Reporting to ORMD
- Investigated (Yes/No)
- Investigation Report Finalised on
- Investigating Authority
- Location
 - Branch Code
 - Name of Branch/Division
 - Name of Group
 - City
- Accountability
 - Name(s) of Accountable Person(s)
 - Designation(s) of Accountable Person(s)
 - Branch/Division(s) Accountable
- Loss Event Details
 - Area of incident
 - Incident Description
 - Risk Type
 - Who Discovered and Reported it
 - Reference Report (If Any)
 - Causes of Loss Incident
 - Action Taken
- Loss Amount Details
 - Direct Loss Amount (Actual)
 - Direct Loss Amount (Estimated)
 - Indirect Loss Amount (Actual)
 - Indirect Loss Amount (Estimated)
 - Recovery Made
 - Mode of Recovery
 - Recovery Expected
 - Mode of Expected Recovery
 - Net Current Loss
 - Expected Net Loss



Perform Rigorous Stress Tests

Approaches to Stress Testing

Sensitivity Analysis	Scenario Analysis
Typically conducted over a shorter time horizon mostly point in time, for example an instantaneous shock.	Typically conducted over the time horizon appropriate for the business and risks being tested
An incremental change in a risk factor (or a limited number of risk factors)	Changes in a number of risk factors, as well as ripple effects that are other impacts that follow logically from these changes
Does not identify the source of the shock	The source of the shock or stress event is well defined, as are the financial risk parameters that are affected by the shock



Perform Rigorous Stress Tests

Key Challenges!!

- Data quality assessment and availability in relevant systems
- Cross-functional collaboration across the bank for streamlined flow of information among the businesses and risk monitoring units
- Consistent Implementation of action plans and Senior Management / BoD oversight
- Enhancements in economic and industrial research output and their integration with scenario analysis
- Enhancements in the design of strategic plans to account for further elements and make it granular
- Necessary enhancements in the budget design to provide RWA and CAR and align with more granular strategic plan



Perform Rigorous Stress Tests

Reaping Benefits!!

- Providing forward-looking identification and assessments of risk
- Overcoming limitations of models and historical data
- Supporting internal and external communication
- Feeding into capital and liquidity planning processes
- Informing the setting of a banks' risk tolerance
- Facilitating the development of risk mitigation or contingency plans across a range of stressed conditions

Risk Management & Basel II - “Deriving Value Beyond Compliance”



Conclusion



Maximise Value Beyond Compliance

To maximise Value Beyond Compliance:

- Ensure continued ownership and support by Board and senior management
- Constitute effective project management structure and team
- Assign Basel Champions from ALL business units and control functions for entity-wide ownership
- Ensure capacity building by inducting/ training at ALL relevant levels
- Introduce accountabilities and mechanism for incentivizing
- Perform on-going reviews of governance, data, systems, processes, MIS to ensure continued value provision
- In parallel, continue to enhance the role and capacity of Internal Audit to be able to perform validations, going forward

Continue to measure and report “Value Beyond Compliance”