



Risk management, Basel II and operational risk

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Any drive towards efficiency generally has its roots in a difficult operating environment. In tough markets, financial institutions typically emphasize cost reduction as revenue generation opportunities dry up. Recently risk management has become an important focus as institutions seek to avoid unexpected losses that often accompany aggressive cost cutting. In addition, corporate governance and the management of credit risk, market risk, and operational risk have become urgent priorities, as has identifying and managing many business risks.

Simultaneously, regulatory imperatives – the Basel II Capital Accord and IFRS – have galvanised Australia's financial institutions in terms of implementing risk management solutions. The new Capital Accord is designed to improve the safety and soundness of the world banking system. To meet the accord stipulations, banks are investing heavily in compliance projects and demanding returns on investments. To assure payback, it is important that institutions address key questions relating to their Basel II strategy, including ways to leverage their investments to improve risk management generally. Banks need to build a compelling Basel II business case that highlights compliance projects can also improve risk-adjusted returns.

The wider benefits

Looking beyond, meeting Basel II requirements can be a catalyst for reinventing risk management's role and overall input into business decision-making.

A major priority is protection of reputation, market standing and credit rating. Beyond this, many institutions are beginning to identify how regulatory compliance can combine with the development of an integrated risk management and information systems strategy. Successful execution will enable risk management to become an integral and natural component of an institution's strategic and tactical business decisions. Thus, for example, individual decisions about granting additional credit

facilities or structuring a collateralised loan obligation can be made with broader insights, including the portfolio implications.

Impact of current and proposed regulation

A persistent criticism of the 1988 Basel Capital Accord relates to serious inconsistency between required capital amounts and the true economic risk of the associated assets. In response the Basel Committee on Banking Supervision proposed to revise the rules resulting in three rounds of consultative papers. These papers have generated extensive feedback from financial institutions, industry associations, consultants, vendors, academics and national regulators with several issues emerging:

- A successful revision with minimal unintended consequences will be far more complicated than first imagined.
- A fully risk-sensitive framework would be too complex to implement for all but the most sophisticated, internationally active banks.
- Ignoring some common forms of risk mitigation within the capital rules will arouse serious political opposition in certain countries.
- Different rules for different institutions can lead to regulatory arbitrage opportunities.

For these and other reasons, while the broad outline of the new Accord appears to be fairly clear, many details will be left to national discretion. It is therefore imperative that banks build a well designed and flexible system architecture capable of adapting to a range of detailed requirements yet to be defined.

The new requirement for operational risk

The most dramatic innovation in the Basel II proposal is a regulatory capital requirement for operational risk. Despite unresolved details, credit risk has long been understood and incorporated into regulatory and economic capital charges. In contrast, operational risk stands as a controversial catchall category. Appropriate measurement methods are the subject of debate and systems are in early stages of development. So what is motivating

banks to move in certain directions and what are the system issues?

- The three main motivations appear to be:
- compliance
 - organisational transformation
 - early warning of future problems

Banks usually exhibit a mix of these motivations with one clearly dominant. This diversity is, at least in part, why there is no single operational risk infrastructure blueprint.

One phenomenon we have seen is a tendency for secondary motivations to increase in importance as a bank gains experience in operational risk management. A consequence of this is the danger of focusing too narrowly on the initial emphasised approach and building an inflexible silo that cannot be extended or integrated with other approaches. System architecture should be flexible enough to integrate the full range of emerging tools and techniques as an institution broadens its approach over time.

Flexibility is key

Dynamic efficiency must be an important consideration in developing a risk management information strategy. Many global banks have complained about the lack of final definition in the Basel II rules. This is only one of many forces at work.

Banking is undergoing a continuing revolution from an "originate and hold" to an "originate and distribute" model of lending. This is driving demand for enhanced data consolidation, analytics and information distribution capabilities. It is likely that the current pace of innovation and associated system enhancements will continue for at least another decade. Therefore only a well designed message-driven system architecture will provide the flexibility to keep up with these growing demands and support more effective decisions at all levels.

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