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INTERVIEW

Experian Decision Analytics combines the credit risk expertise of Experian-Scorex and fraud and identity management capabilities of MCL Software, another business of the Experian Group. Alina Tanasa of its global consulting team, talks to CRO on Basel II in an email interview.

CRO: What are the current best practices in credit risk management under internal ratings based (IRB) approach of Basel II ?

Alina Tanasa (AT): Nowadays, in the Basel II IRB approach to implementation, the hottest topic is satisfying the 'use test' requirement. The 'use test' requirement - a major criterion for qualitative validation, is the actual use of rating results in banks' internal risk management.

From a conservative point of view, the way in which a bank uses its rating system for internal decision-making processes reflects the confidence it has in its own system. Wherever banks' own rating systems are not used internally or are used only for individual, isolated purposes, this can be interpreted as a deficient quality of the rating system.

The Basel Committee provided few guidelines in the Accord itself on how the risk inputs can be used operationally, stating simply that they must play an essential role in the credit approval, risk management, internal capital allocations, and corporate governance functions' (paragraph 444). Here, it is clearly stated that models used just for regulatory capital calculations will not be accepted. The Committee subsequently published a newsletter in September 2006 with more guidelines on the Use of IRB Components'.

Despite the importance of the 'use

test' being emphasised so many times by the regulators, some of the banks we are working with are still reluctant to implement it. On the other hand, many financial institutions have already reviewed their selection practices and put in place the use test requirements as a first action. Moreover, Experian Decision Analytics has been providing consultancy to a number of clients for effective and efficient use of the IRB risk inputs in the daily business.

CRO: With supervisory review mandatory under Pillar Two, is it necessary for banks to develop their own models, or is it possible to use the available popular credit risk model implementations?

AT: The banks are allowed to use generic models (scorecards) as long as they can prove that they have been built on a population with a similar risk profile and that the models are performing properly on their own portfolio (eg high discriminatory power, stable and calibrated to the correct definition of default). However, these models must be closely monitored over time, and when enough internal data is available, bespoke models should be built as internal data is the key factor in the risk inputs estimation process.

CRO: Does Basel II create a regulatory arbitrage in favour of large banks that can invest in the risk management process? Will this result in relatively riskier borrowers to gravitate towards smaller banks with less developed

risk management systems?

AT: One of the advantages that Basel II implementation offers to financial institutions is the opportunity to fundamentally revise their business processes. This means that by implementing the Basel II requirements, a bank is able to reform and merge its risk management and finance functions, and also to centralise and improve control of its data. This is something that any institution can benefit from.

In most cases, implementation is a large investment for small and regional banks, but the return in terms of reduced regulatory capital and recognition in the market are a desirable outcome. Also, very often, smaller banks have a regional or local focus, with a very tight link to the local environment that can play a major role in developing its local business.

CRO: Will moving to advanced approaches necessarily result in lower regulatory capital on account of credit risk?

AT: Not always. When the Basel Committee developed the Basel II Accord, it always stated that the new framework would try to keep capital levels unchanged for a bank with an average risk profile. In other words, for financial institutions that tend to have a higher than 'normal' risk profile, the minimum capital requirements should increase, and vice-versa for the others.

Now, this overall capital objective is intended to cover all the risks that the banks face: credit, market, operational risk and a number of other risks not covered in Pillar 1. As the operational risk and the Pillar 2 risks were not incorporated into the current Accord, to attain this objective, the credit risk capital requirements will definitely be lower under Basel II as the market risk requirements have not changed since 1996 when they were published.

In summary, there is already a capital reduction for the banks implementing the Standardised approach (eg the risk-weight applied to the retail exposures was reduced from 50 percent to 35 percent for mortgages, and from 100 percent to 75 percent for other retail exposures). The capital reduction is even higher for a bank implementing the IRB approach, as illustrated in the Table 1 of the QIS 5 results reproduced here. However, it is important for the banks to have the correct regulatory capital, the capital that will best reflect the institution's risk profile.

CRO: Is it possible to have differential risk-based pricing for retail assets?

AT: Different assets have different characteristics (eg risk, maturity, structure) and these must be

taken into appropriate consideration when pricing them, so having a differential risk based pricing for retail exposures should not cause any problems. And, even within the same asset class, we can have differential pricing based on the risk, eg expected loss rate.

For instance, pricing a mortgage requires having risk drivers 'calibrated' in the long term (not the regulatory one-year horizon), whilst pricing a revolving product may also require that EAD (exposure at default) may be lower than the current balance (if the model is sophisticated enough to be able to estimate that). If there are any changes to the regulatory risk drivers, the banks are required to demonstrate and document the reasons behind these choices. Furthermore, Para 444 states that '... It is recognised that banks will not necessarily be using exactly the same estimates for both IRB and all internal purposes. For example, pricing models are likely to use probability of default (PDs) and loss given default (LGDs) relevant to the life of the asset. Where there are such differences, a bank must document them and demonstrate their reasonableness to the supervisor'.

CRO: Basel II adoption involves considerable investments. Do you think that banks of all sizes can



Biography

Alina Tanasa is a member of the global consulting team of Experian Decision Analytics and is based in Monaco, with specific remit to provide consulting services in banking and on Basel II. A graduate in Economics from West University, Timisoara (Romania), Alina holds a master's degree in International Finance, Ceram Sophia Antipolis (France). Her career spans six years in the financial services industry. Initially working for Citibank in an operational role in Romania, Alina has since worked as a consultant for Finconet (specialist consultancy for credit risk analysis and country risk assessment) and Experian Decision Analytics. She has an in-depth knowledge of the Basel Accord and its application, specialising in the areas of retail credit risk. She has participated in a number of projects ranging from delivering Basel II gap analysis to evaluating and enhancing collections of KPIs.

Table 1 Incentive structure Minimum required capital for foundation IRB relative to standardised, and minimum required capital for advanced IRB relative to foundation IRB, in percent		
	Foundation IRB / standardised	Advanced IRB/foundation IRB
G10 Group 1	-13.3	-5.1
G10 Group 2	-8.1	-6.6
CEBS Group 1	-13.5	-6.8
CEBS Group 2	-12.4	-6.7
Other non-G10 Group 1	-20.6	-7.3
Other non-G10 Group 2	-19.9	-11.0

obtain a reasonable return on this investment in the form of improved asset quality and reduction in regulatory capital?

AT: Yes, there is no doubt about this. The New Basel II Accord emphasises the importance of best practice risk management and it will also underpin the stability of banks. Paragraph 4 - The Committee believes that the revised framework will promote the adoption of stronger risk management practices by the banking industry, and views this as one of its major benefits'.

Basel II is not just another regulatory burden as it is also providing an opportunity to fundamentally revise business processes. By implementing the Basel II requirements, banks are able to reform and merge their risk management and finance functions and also to centralise and better manage and control their data.

Furthermore, the banks implementing the most advanced approaches are likely to secure a considerable competitive advantage by reducing their regulatory capital requirements (as the Committee offered capital incentives for the banks implementing the most complex approaches), thus increasing their capital while financial institutions that fail to implement the necessary IT environments will operate at a significant competitive disadvantage.

CRO: According to analysts, banks governed by Basel II (capital tied to risks) will loosen credit in 'good times' (when risk perceptions are low), and restrict it when times are 'bad' (when risks rise again). If most banks act

in this fashion this would accentuate the crisis in bad times, jeopardising stability. Do you think Basel II and the risk-based supervision approach that it attempts, makes the banking system susceptible to business cycles?

AT: This situation already existed prior to the introduction of Basel II. In order to minimise their exposure to bad debt, financial institutions will adjust their lending strategies according to the conditions prevalent in the markets in which they operate. This is not quite as simplistic as loosening a strategy in good times and tightening it in bad, since an institution will set the strategy based upon its best estimate of where the economic conditions will lie over the term of the exposure. Strategy will also be adjusted by product to account for the variance in average time for debt to manifest in each. It is by this approach that financial institutions have historically sought to mitigate against the impact of economic shifts and I would see the Basel II Accord supporting such measures rather than introducing any practices likely to destabilise their ability to withstand recessionary conditions. Finally, cyclical issues will be lessened through the use of long-run average estimates of the risk inputs used in the Risk Weighted Assets and minimum capital requirements calculations.

CRO: What are your experiences in Basel II implementation so far?

AT: So far, we have implemented more than 70 Basel II solutions in more than 30 countries, including Top 3 banks from Australia, France, Greece, South Korea, South Africa and UK, and for the

development the Basel II IRB approach models for a large Eastern and Southern European banking group. Moreover, we will provide the Strategy Management decision engine technology enabling HSBC to deploy a series of Basel II models within its global operations. Strategy Management is Experian Decision Analytic's decision support solution that provides the business user with the ability to deploy scoring models, portfolio segmentation, decisions, and actions to control and manage its customer relationships. We have established ourselves as a leading provider of solutions for the New Basel Capital Accord (Basel II) by working closely with our existing banking partners since 1999 and subsequently with a broad cross-section of financial institutions and national regulators. The requirements of Basel II are an extension of this discipline and fall naturally into the skill set that Experian Decision Analytics has developed for over twenty years.

CRO: What is your advice to banks on credit risk management?

AT: As I mentioned previously, the effective use of rating results in banks' internal risk management is a hot topic at the moment. But I have to highlight that credit risk management is not only a priority for banks but for all financial institutions active in the European Union. Many financial entities have already moved toward the enhancement of their credit risk management practices as they see a real opportunity to exploit it in more competitive markets. The fact that finance houses and leasing companies have also implemented the Basel II advanced IRB approach is proof of this. ■