

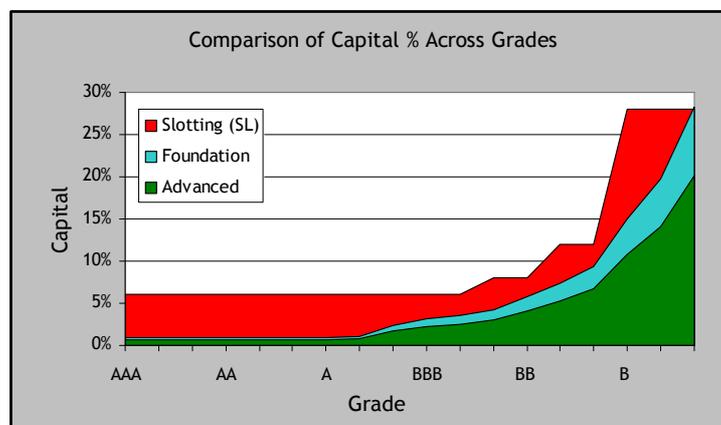
Editorial in *Finance Today*, November 2004

Basel's Benefits and Challenges

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Risk Integrated provides technology and methodology to help clients assess risk for commercial real estate and project finance. Our products have been developed through extensive work with experts in their fields - regulators, lending officers, risk managers and IT departments - giving us a broad view of the intermediate struggles and ultimate benefits of Basel implementation.

The 1988 Basel Accord required capital to be simply 8% of assets. The 2007 Accord allows banks to use their own models to assess capital for credit and operating risk. The Accord's objective is to force banks to improve their risk measurement abilities and increase transparency. This should reduce overall losses, and more importantly, reduce destabilizing surprises. The incentive embedded in the Accord is the principle that banks with sophisticated risk systems will be allowed to hold less capital. The graph below shows the amount of capital that must be held against specialized lending assets under three of the allowed approaches: Slotting, Foundation, and Advanced. For the same assets, required capital may be halved if the bank has models that qualify for the Advanced approach rather than Slotting. A reduction in capital instantly increases the return on equity, allows more competitive pricing, and improves the banks debt rating.



There is no single methodology for calculating capital. The bank must choose the methodologies it finds most appropriate, and best able to justify to the regulators. If the bank can extract a great deal of historical default data on deals similar to its current assets, the regression approach is most straightforward. If publicly traded equity information is available, the Merton approach can be used, and if the assets have complex structures as in project finance, simulation can be used.

Prototype models are typically built in Microsoft® Excel, but banks are finding that the implementation of that model as a live integrated system can take much longer than the original project, leaving spreadsheets scattered across the bank. A high "Excel-Index" leaves the bank open to operating risk and unable to comply with Basel requirements for auditability and makes it very difficult to compile the consolidated reports needed to satisfy Basel's heavy requirements for internal and external reporting (Pillar 3).

Even with good models, it is not easy to qualify for a reduction in capital. Basel requires accurate risk calculators, integrated deeply into the banks systems, processes and culture. There are four main challenges in implementing Basel: building risk models, creating live interfaces from the core banking systems into the models, persuading users to enter data, and finally educating everyone, from line-management to senior management, to use the results.

Driving and managing the required changes is proving to be difficult and complex, straining the bank's capacity and often burning out the individuals assigned to the task. Although much of the media focus is on the methodologies, the brunt of the implementation falls on the IT department. The changes are so far reaching, that many banks have been prompted to undertake a complete overhaul of their IT infrastructure.

All banks will eventually get there, and the banks and economies will be better for it. But there is much to do and only a few leading banks will be ready by the end of 2007. The rest will catch up as they are chased by the market and investors. Don't expect a big bang in 2007, it will be more like rolling thunder.

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