

Optimising the capital ratio under Basel III

With Basel III expected to provide an incentive for further integration of data management and analytics into an enterprise-wide risk management platform, Moody's Analytics discusses the key challenges institutions face when optimising and integrating the capital ratio

As banks adjust to the realities of implementing and complying with Basel III, much of their management focus has now shifted to how to manage and develop their businesses while remaining compliant. Senior managers are now looking at how to best manage their capital, data and systems, while complying with regulations. Their objective is to ensure that their risk, compliance and business profiles are fully aligned.

Many are focusing on how to effectively optimise their capital ratio under Basel III, to ensure that they comply with the regulations and address the significantly greater capital demands of Basel III.

This article is based on Moody's Analytics white paper, *Optimizing the capital ratio under Basel III*, which is available to download at www.moodyanalytics.com/capratio2013

Regulatory background

Basel III replicates Basel II by using the capital ratio approach to assess financial solvency. However, the definition and the components of the capital ratio have been revised and require institutions to hold more, and higher-quality, capital.

These enhancements include higher weights for exposures to market risk and counterparty credit risk, and a capital charge for credit valuation adjustment, for example. Basel III also introduces an additional leverage ratio, which will have a significant impact on the capital ratio calculations and the capital structure of financial institutions.

Given Basel III's new capital requirements, banks have an incentive to develop an enterprise-wide capital ratio calculation and reporting framework. This helps them comply with the regulations, optimise their capital ratio and reduce their cost of capital.

Optimising risk-weighted assets

Risk-weighted assets (RWAs) are central to the calculation of a financial institution's capital ratio, allocating an amount of capital to its assets, based on risk and exposure. Basel II and III have broadened the remit to include additional credit, and operational and market risks that may affect a financial institution's balance sheet. Regulatory arbitrage has been reduced between banking and trading books by introducing counterparty and migration risk capital charges.

However, banks looking to optimise their RWAs face numerous challenges. The hurdles they must overcome cover data quality management, risk and balance-sheet management, risk modelling and calibration, as well as managing multiple regulatory regimes and requirements.

Optimising the tier capital

The constraints Basel III places on earnings are an incentive for capital ratio optimisation, through the precise allocation of capital and the accurate calculation of capital deductions. Institutions are analysing their risk appetite and balance-sheet composition to optimise their RWAs and maximise the use of scarce capital resources.

Basel III dramatically increases the interconnectivity of the RWAs and tier III capital calculations. The calculation of eligible capital and deductions is now fully embedded as part of the RWA calculation. This demands a new enterprise-wide infrastructure for managing tasks, processes and calculations.

Integrating the capital ratio calculation into enterprise-wide risk management systems

Calculating and optimising the capital ratio encompasses all aspects of a bank's risk management systems and processes. The optimal solution would centralise and consolidate a bank's risk data into a central data platform. Powerful calculation engines, with all the RWA-eligible deduction formulas already built in, would provide swift and accurate results. Comprehensive reporting systems would provide management with reports to make fully informed, risk-based decisions to optimise their capital ratio. These reporting systems could also deliver accurate and consistent regulatory reports. Fully integrated stress-testing systems would allow bank management to leverage forward-looking scenarios to assess and manage their response to changing economic, market and regulatory conditions.

The optimal solution would offer these elements as a single, integrated and streamlined solution. This would allow banks to efficiently and effectively optimise their capital ratio, reduce their cost of capital, as well as meet their regulatory obligations. This approach would enable banks to balance the needs of the business and regulators, as well as meeting strategic objectives.

To read the full Moody's Analytics *Optimizing the capital ratio under Basel III* white paper, visit www.moodyanalytics.com/capratio2013

To learn more about how Moody's Analytics can help you manage Basel III compliance and risk management, visit moodyanalytics.com/riskauthority

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