# What it Takes:

## Turning Basel II Compliance into a Competitive Edge

The heat is on. The ideals and debates have given way to the hard realities of compliance, and time is running out. But rather than engage in a reactive scramble to demonstrate compliance, firms can use the regulatory imperatives of Basel II as an opportunity to push ahead of the competition.

Firms that take a strategic look across the enterprise and adopt a forward-looking perspective can cost-effectively build a powerful competitive advantage for today and tomorrow. How are you shaping your infrastructure to support the greater demands of data capture, data mining and risk management? Which models and information sources are you using to validate and enrich your own credit risk analysis? How will you demonstrate a robust risk management culture, from the boardroom to the back office?

# The Challenges

In this new world order, financial institutions will need to:

- **Establish a robust infrastructure.** Strengthen systems and processes and establish strong information controls. Demonstrate the ability to systematically track operational losses and risks by business line and to support the greater data demands.
- **Establish a strong risk culture across the organization.** Adopt practices and processes that support risk awareness and management.
- **Accurately aggregate exposures across the enterprise portfolio.** Demonstrate the ability to reliably measure and mitigate risks across asset classes, and to ensure diversification and reduce conflicts of interest by identifying relationships across the global portfolio.
- **Reliably assess credit and operating risks.** The first tenet of Basel II mandates that firms, with a strong international presence, adopt a methodology for computing capital reserve requirements that accurately reflects the firm's risks. Depending upon size and structure, a firm may rely on the assessments of a credible third party or build and externally validate an internal ratings model. The advanced methodologies rely on ready stores of detailed credit risk information, such as probability of default and loss given default data. The quality and availability of the underlying data is paramount.

# Solutions

**Establishing An Infrastructure that Supports Compliance**

Basel II and other new regulations pose new challenges to banks. Amid the cries for greater disclosure and transparency, there are new accounting wrinkles and more complex algorithms for assessing the risk on different types of transactions and counterparties. All of these present technological challenges in implementation and compliance.

More than ever, there is a strategic need to master the data that's collected across the organization and to be able to analyze and serve it up in meaningful ways and in real time. Central to these increased demands is a robust infrastructure and data that can be shared and mined across applications and systems.

In a time of information overload, it is not the amount of information that's in question but whether it's the right information and in a format that can be readily analyzed. For cost reasons, many organizations have taken a piecemeal approach to upgrading systems and automating key processes. M&A activity often exacerbates the issue, culminating in a sub-optimal mix of old, new and hybrid systems and processes. Critical data may be housed in different systems and categorized in non-compatible lexicons. In order to comply with the demands of Basel II, banks will need to make the time/money investment to develop systems and processes that enable them to efficiently collect, store and draw on the data.

By using Basel II and other mandates as the catalyst for an enterprise-wide examination and refinement of its infrastructure and processes, a firm can achieve significant operational efficiencies and improvements. An effective action plan would include: eliminating redundancies in applications, standardizing processes, establishing a system of information protection controls, and adopting best practices that decrease the overall operational risk of the organization.

**Forging A Risk Culture that Reduces Operational Risks**

How is a risk-savvy culture created? Desired risk management practices must be supported at every level of the organization. Central to that is a process for ensuring compliance with a documented set of internal policies, controls and procedures. These policies must reflect not just the prevailing wisdom of the regulatory watchdogs, but also the longer-term business objectives of the organization.

Corporate governance and internal controls are essential; at the highest levels, there needs to be assurance that there are appropriate controls for the inputs, sound processes for obtaining capital estimates and ratings, and that these all support the larger risk strategy.

**Aggregating Risks Across the Portfolio**

Although Basel II may not be in full force until 2007, the time to act is now. Financial institutions whose national regulators endorse the code (all the EU, the G-10 and most other developed economies) must take steps now that will ensure compliance.

How does an institution continually present an accurate picture of its own aggregated and counterparty risk across all the disciplines of investments, loans, trading books, derivatives and other exposures? A lending institution needs a complete profile of each counterparty in order to properly weight different credit default scenarios. Firms need access to detailed knowledge of all the other indebtedness within those borrower and counterparty organizations to accurately show potential losses.

This means compliance and risk management teams need to consolidate as much information as possible to be able to produce a true credit risk picture across the spectrum of the bank's activities. They need to fully comprehend their data needs and adopt methods that will enable them to accurately measure loss, based on the data.

In addition, one requirement is a database of all operational losses and exposures in the preceding three years. The priority on delivering this in an auditable and robust fashion will demand extensive and sophisticated data collection and consolidation. Internal data must be easily accessed and analyzed alongside reliable third party credit research and data.

Banks must make decisions today that will ensure not just their ability to comply with regulations, but their ability to compete long-term.

**Reliably Assessing Risk and Capital Requirements**

The less capital that needs to be set aside for unexpected losses, the more that's available for investment and growth. By demonstrating that capital reserve calculations are in line with risks, firms may be able to free up more of their working capital, or return capital to shareholders. To do this, a firm needs to:

- Develop a framework for measuring, monitoring and mitigating risks.

- Adopt an approved methodology for computing capital reserve requirements. Firms must demonstrate that they can measure credit risk reliably, either by accepting the ratings of a third party, such as Standard & Poor's, or by building an internal ratings model that is validated with credible third party data. Banks that employ internal ratings systems must clearly and objectively define ratings categories and criteria and apply them in a consistent manner.

  By adopting an effective internal rating system, a firm can demonstrate that it understands the credit quality of individual assets as well as the overall portfolio. The payoff is a potential reduction in lower capital requirements, but even more importantly, stronger decision making capabilities. Greater insights lead to better decisions about each risk driver, and ultimately stronger risk management.

- Track all of the elements that comprise expected credit loss, such as probability of default, loss given default, and exposure at default.

- Methodically measure and monitor operational risk events.

Financial institutions need to define the data requirements, the mechanisms to collect, analyze and report the data, and a methodology for cost-effectively implementing the system and process enhancements to make it happen.

It will also mean that in order to have confidence in the end results, financial institutions will need to rely heavily on the credibility and information of suppliers, their data consistency and the application of dependable tools.

# How Standard & Poor's Can Help

For more than 140 years, Standard & Poor's has been one of the world's leading experts in credit risk assessment and research for the financial services sector. Standard & Poor's builds on that experience to create products and services that may help companies comply with many of the demands of the new regulatory environment. Similarly, Standard & Poor's has made available risk management products and services that may help firms strengthen their risk management capabilities.

**The following Standard & Poor's services may be an important part of your risk management solution:**

## RatingsXpress

Standard & Poor's RatingsXpress is a real-time (ASCII or XML) feed of global credit ratings and detailed risk data that can be readily integrated into the firm's systems. RatingsXpress draws on Standard & Poor's worldwide database of ratings and research for more than 10,000 active issuers and over 70,000 issues, including historical data going back to 1922. Standard & Poor's ratings are an objective and independent measure of credit risk.

**RatingsXpress enables firms to:**

- Use credible credit ratings for computing risk and capital reserve requirements.
- Validate an internal ratings system.
- Integrate and readily access and filter detailed credit risk information.
- Reduce processing errors and improve efficiencies.

If you are interested in attending a Standard & Poor's Basel II forum in London, September 2004, please contact us at **emea-marketing@standardandpoors.com**

STANDARD & POOR'S

## Security to Entity CrossWalk

Standard & Poor's, Telekurs and D&B have joined forces to produce CrossWalk, a powerful securities/entity cross-referencing service, that links the relationship between securities, identifiers and issuers. CrossWalk contains as many as five million securities, referenced to 65 national and international security identifier numbering systems and to D&B's unique D-U-N-S® Number and corporate linkage to offer a 360-degree view of total risk and opportunity across related businesses.

**CrossWalk enables firms to:**

- Improve management of both company and industry investment risk through a clearer understanding of corporate entity, subsidiary and affiliate exposure.
- Highlight the corporate entity hierarchy behind individual securities worldwide and provides insight designed to help any organization enhance both investment-risk and compliance management.

## Risk Solutions: Integrated Credit Risk Management Solutions

Standard & Poor's Risk Solutions works directly with clients to develop, enhance, and validate their credit assessment processes, collect and analyze data, model credit risk and train staff. These services can help banks with their internal rating systems whether they've chosen the foundation or advanced approaches to credit risk under Basel II.

**Risk Solutions enables firms to:**

- Obtain hands-on assistance, training and risk management solutions, customized for their firm.
- Validate credit assessment processes.
- Enhance data quality and analysis.
- Develop credit risk models.
- Assess the probability of default and obtain credit scores for companies not traditionally rated by Standard & Poor's (Credit Risk Tracker).
- Project loss given default on loans and debt securities. (LossStats Model).

The combination of these credit risk products and services, and the evolution of more sophisticated modeling and credit risk services puts Standard & Poor's and its customers in the forefront of solutions for risk management.

For more information about each of the products or services featured, contact Standard & Poor's at **www.standardandpoors.com/basel2**

**CrossWalk** 1.212.438.1740 **RatingsXpress** 1.212.438.2774 **Risk Solutions** 1.212.438.7438

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