



Institute of Actuaries of Australia

2004 Financial Services Forum ...The New Environment

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Basel 2 & Actuaries

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Agenda

- What is Basel 2?
 - Overview of changes
- Potential for actuarial involvement
 - Case Study – Operational Risk
- Strategic Impacts of Basel 2

What is Basel 2

- Basel 2 is the set of capital requirements for banks issued by the Bank of International Settlements
- Replaces original Basel framework
- Exists alongside the national banking regulator in each country

Components of Basel 2

- Basel sets framework for assessment of capital requirements and risk management
- Three major components:
 - Pillar One : Regulatory Capital Calculations
 - Pillar Two : Stress testing analysis, validation reports
 - Pillar Three : Reporting

Key Changes

- Introduction of Operational Risk
- Introduction of flexibility of approach
 - Basic
 - Standardised
 - Advanced
- Linkage of calculation methodology to risk management actions
 - Capital benefits available to those who take on most advanced risk management frameworks

Important Dates

- April 2003 – CP3 Released
- September 2003 – QIS3 Released
- June 2004 – Final Basel II requirements Released
- Late 2005 – Banks using Advanced Basel II methods will run in parallel with Basel I for one year prior to Basel II implementation
- December 31 2006 – Basel II in force for large international banks in major economies
- Late 2008 – Basel II single capital floor ends

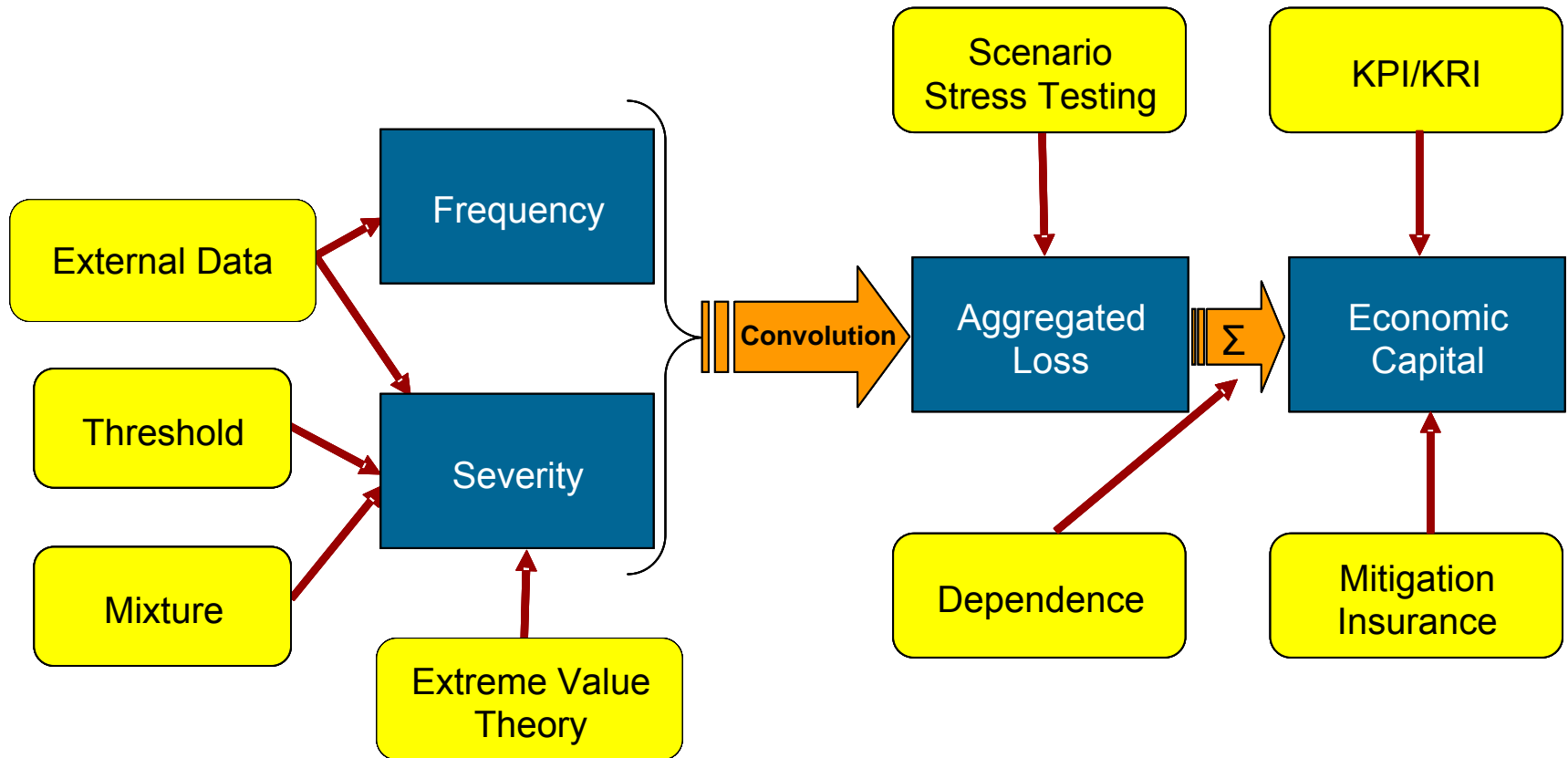
Opportunities for Actuaries

- Advanced requires quantitative analysis closely aligned with actuarial skillset
 - For some elements, actuarial methodology gathering high degree of international acceptance
- Actuarial involvement has been extensive in overseas markets

Case Study – Operational Risk

- Basel 2 introduces operational risk as a risk requiring regulatory capital, similarly to credit or market risk
- Three proposed approaches

Case Study – Operational Risk

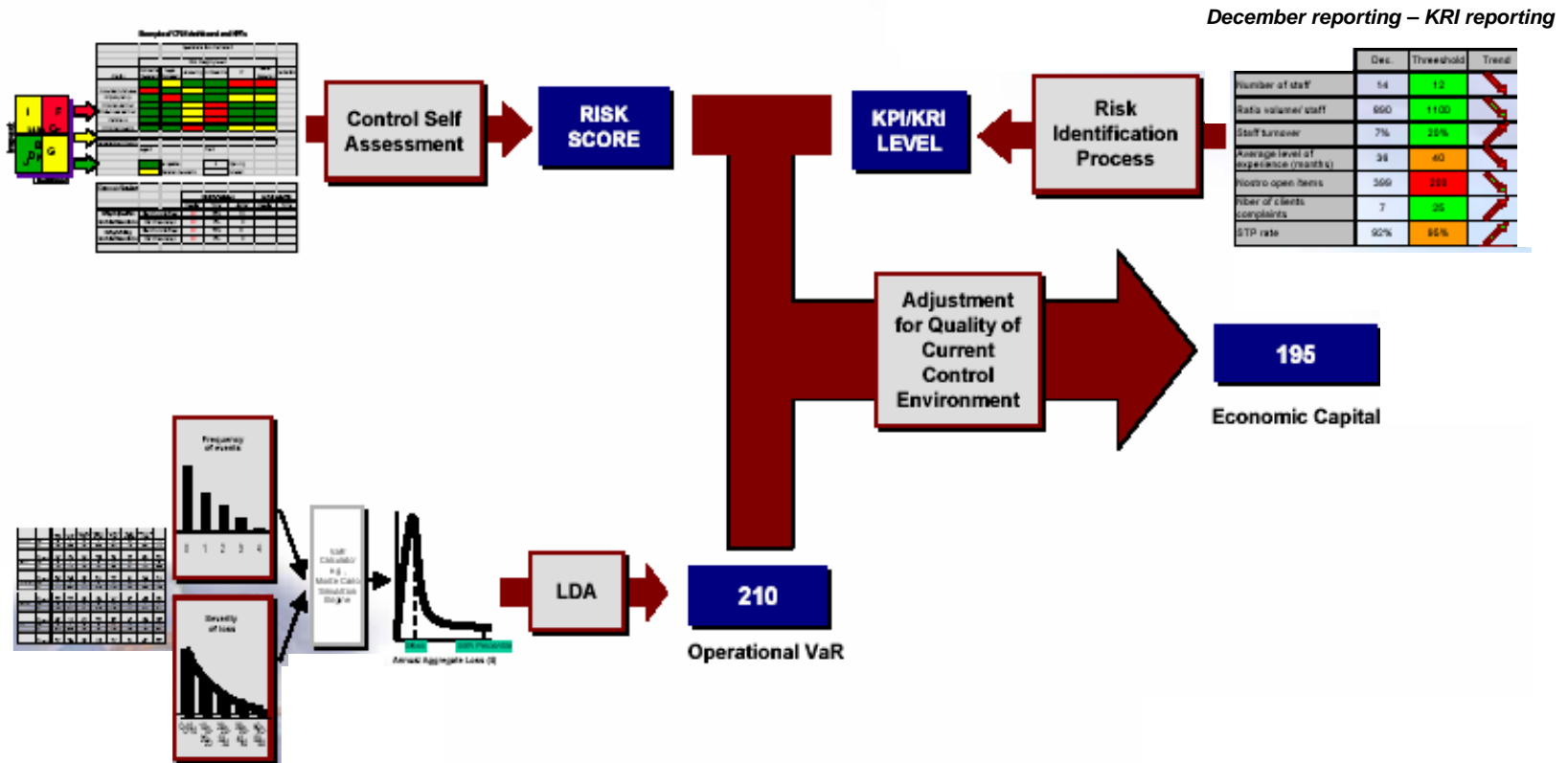


Case Study – Operational Risk

- Complex issues requiring resolution:
 - Choice of severity distribution
 - Assessment of operational value at risk
 - Collection Threshold
 - Allowance for extreme events
 - Not generated by same distribution
 - Dependencies between risk
 - Inclusion of external data

Operational Risk – Linkages between elements

Adjustment of the economic capital computed with the quantitative methods with some qualitative aspects (KRI and RCSA) in order to reflect the evolution of the bank's risk profile.



Basel 2 Changes – Overview Implications

- Implications of the changes in capital requirements are wide ranging:
 - Closer alignment between economic and regulatory capital
 - Potential for banks taking different approaches to have ability to use relative capital benefits to impact market outcomes
 - Major investment in quantitative analysis for those banks seeking to achieve advanced status

Basel 2 Changes – Global Analysis of Impact

- QIS3 analysed impact on major global banks of proposed structure¹ at time of preparation (2003)
- Analysed outcome for various groups of banks
 - Group 1 – large, diversified and internationally active with Tier 1 capital in excess of €3 billion
 - Group 2 – smaller and often more specialised banks
- Based on version of Basel 2 rules set out in Consultation Paper 3 (CP3)

Basel 2 Changes – Global Analysis of Impact

- Summary of Findings – Overall Change in Capital Requirements

| | Standardised | IRB Foundation | IRB Advanced |
|---------|--------------|-------------------|--------------|
| Group 1 | +11% | +3% | (2)% |
| Group 2 | +3% | (19)% | n/a |

Basel 2 Changes – Global Analysis of Impact

- Variation across banks
 - Relative quality of exposures
 - Relative proportion of retail exposures

Case Study – Mortgage Portfolios

- Retail Mortgage portfolios expected to show significant reduction in regulatory capital allocated under all calculation approaches

| | Standardised | IRB Foundation | IRB Advanced |
|----------------|---------------------|-----------------------|---------------------|
| Group 1 | (27)% | (53)% | (58)% |
| Group 2 | (20)% | (44)% | n/a |

- Banks with significant retail mortgage portfolio therefore likely to gain relative advantage
- Risk weights significantly lower than current 50% for all approaches

Basel 2 Changes – Australian Overview of Impact

- APRA position
 - Yet to be defined in detail
 - Key concern on competitive impacts
 - Expected to issue Australian requirements later this year
- Rating Agency position
 - Rating Agency position may be for the status quo

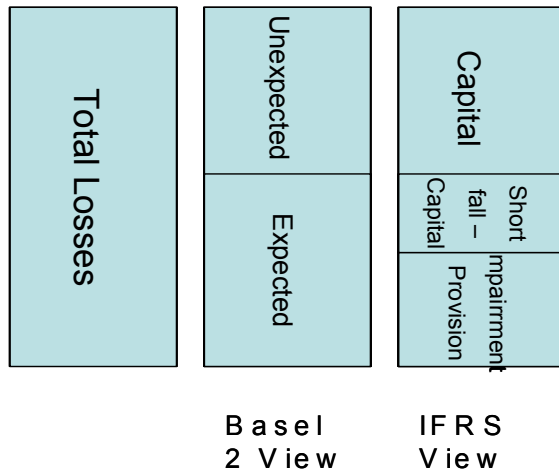
Basel 2 Changes – Strategic Impacts

- Competitive advantage
- Barriers to entry
- Information advantage
- Relative attractiveness of securitisation
- Distribution channel attractiveness
- Use of excess capital
- Impact on Ratings

Basel 2 Changes - Reporting

- Different approaches under Basel vs IFRS

New reporting requirements



Current reporting requirements

