



FEEDBACK ON SURVEY OF BANKS' PREPARATIONS FOR THE NEW BASEL CAPITAL ACCORD

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EXECUTIVE SUMMARY

We have for a while been interested in the positive developments happening in the regulatory field, especially the proposed New Capital Accord ('Basel II'). We were aware that banks faced a huge workload in implementing the accord against a tight timetable, a task made more complex by the major uncertainties introduced by the lack of finality in the consultation process.

Accordingly, in July/August, we ran a survey to take a snapshot of the state of banks' preparations in this field. We were expecting a widely divergent state of readiness to the BCBS's proposals and so we deliberately targeted a wide cross section of banks and building societies.

We found that most banks are pressing full steam ahead with their detailed planning for implementing Basel II, notwithstanding the uncertainties surrounding the decision of the Basel Committee to delay publication of the final version of the Accord until early next year and to postpone the cut-over date from 2004 to 2005. Such banks are looking to complete the planning stage by the end of 2001/early-2002, with a view to completing most of the detailed implementation work over the ensuing 12-18 months.

However, we did find a significant rump of banks (circa one-third of our sample) who had decided to defer serious planning for Basel II, pending release of more finalised proposals from the regulators. Such banks tended to be smaller, less complex institutions.

In terms of detail, banks seem to have a fairly clear idea of the nature and scope of work required to implement the credit risk proposals. Over half of the banks are aiming to adopt the Advanced Internal Ratings Based (IRB) Approach. Interestingly, one bank that aims to implement the Advanced IRB eventually is probably going to opt for the Foundation IRB in the interim because, on a strict interpretation of the requirements, they would not have built up the requisite track record by 2005.

Unsurprisingly, banks are less decided as to how they will tackle the operational risk proposals: as many as 45% of the banks surveyed were still undecided, pending the release of more detailed and finalised proposals from the regulators.

Most banks acknowledge that the Pillar Three disclosure requirements are theoretically straightforward, but onerous: the feedback is that meeting the requirements - at least, as currently framed - will be a severe logistical challenge.

Overall, banks highlighted the following overarching challenges in complying with Basel II: data management, securing senior level buy-in to the scope and cost of the project, coping with delays and uncertainties, implementing cultural reforms and balancing the needs of the project with other management priorities.

Very few banks have established a budget for the whole Basel II project as yet. Further, few banks have yet done any serious thinking on the overall costs/benefits arising from the project, factoring in changes in the cost of regulatory compliance and of the level of regulatory capital held, plus other targeted by-products of the compliance effort (such as improved RAPM, capital allocation and portfolio management techniques).

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SUMMARY OF OVERALL APPROACH

Reprise: Summary of Basel II

In 1999, the Basel Committee on Banking Supervision ('BCBS') proposed overhauling the existing framework for the regulation of banks (the 1988 Accord, as amended), via the introduction of a 'New Basel Capital Accord'. The thrust of the new Accord is a 3 Pillar Approach, supplementing the calculation of capital adequacy requirements with pillars covering supervisory review and market disclosures.

By way of a simple summary, the main areas of change are as follows:

Pillar One - Minimum Capital Requirements

The New Accord proposed major changes for credit risk and the introduction of a charge for operational risk. Market risk is unchanged from 1996 Amendment.

Credit Risk: In a welcome overhaul of the existing 1988 Accord, there is a choice between 3 increasingly sophisticated methods: the Standardised, the Foundation Internal Ratings Based ('IRB') and the Advanced IRB Approaches. The logic is that a more complex approach (and therefore a more sophisticated risk management process) should lead to a lower capital charge, via a deliberate bias in the way the charge is calibrated and a more favourable treatment of credit risk mitigation techniques. As a quid pro quo, there are increasingly onerous qualitative standards to meet. It should be noted though that the market feedback suggests that the initial calibration falls foul of the stated objective; greater clarity is also needed in some areas.

Operational Risk: There is again a choice of approach: between a standardised and a more sophisticated Internal Measurement Approach ('IMA'). However, it is clear that the proposals in this area are less well defined.

Pillar Two - Supervisory Review Process

This pillar establishes four principles that the supervisors are to follow in their review of banks, including assessing quality of management and adequacy of capital plans, with a duty to intervene if a bank's capital levels fall below a required minimum.

Pillar Three - Market Discipline

This pillar sets out extensive disclosure requirements in respect of a bank's risks, with banks adopting the more advanced approach subjected to more onerous requirements (in terms of extent and frequency of reporting).

The most recent full set of consultation papers (dubbed CP2) came out 16th January 2001, with comments invited in by 31st May 2001. On the back of feedback received, the BCBS on 25th June 2001 pushed back the target implementation date from 2004 to 2005. The BCBS is in the middle of producing reworks of key sections (most notably, the treatment of retail, equity and project finance credit exposures, operational risk and disclosure requirements), based on the feedback received and in conjunction with various industry steering groups. Indeed, new proposals have already issued on the treatment of provisions and of equity holdings in the banking book.

We understand that the next and (hopefully) final version of the consultation papers (CP3) is due out early in 2002.

Overview of Survey

We conducted the survey in July-August 2001, with the aim of taking a snapshot of banks' preparations for Basel II.

We expected a widely divergent reaction to the BCBS's proposals and so we deliberately targeted a wide cross section of banks and building societies. This included major UK and international banks (including leading banks from 4 European countries) at one end of the spectrum, down to small domestic institutions at the other.

Within these institutions, the respondent was a senior figure within the Basel II project, or the area that will own the project when established. This was we found most typically from group risk management, often group credit risk.

Interviews were conducted based on a standardised questionnaire.

Summary of Overall Approach to Implementation/Project Outline

Current Project Status

All banks reported having done some preliminary high-level review work on Basel II, with at the very least information papers being submitted to the Board.

However, we noted in our survey that the market is polarising into two camps.

Within the majority of banks (roughly two-thirds of banks surveyed), the Basel II project is progressing full speed ahead, notwithstanding the delay in issuance of CP3 and the deferring of the target cut-over date from 2004 to 2005.

By contrast, the other banks surveyed are deferring any serious consideration of Basel II until the final round of consultation papers are published.

As to the composition of players into the two groups, the larger and more sophisticated players were all pressing ahead with their Basel II projects. We believe that this is driven by three factors:

- Given the nature and scale of their operations, completing the project for the original deadline of 2004 would have been a stretch.
- These banks are represented on the various industry working groups (ISDA, BBA etc), and so can anticipate revisions to the existing proposals.
- Such banks are not overly resource constrained.

By contrast, in general smaller houses seemed happier to defer serious work at this stage and indeed tended not to have done much serious planning at all. The primary reasons for delaying preparations were:

- Awaiting the greater clarity that will come from the publication of finalised proposals and deadlines;
- Resource shortage, both of management and of risk know-how: for example, UK houses currently have a major resource conflict due to the burden of preparing for the move to a single regulator under the Financial Services and Markets Act 2000 (an event known as N2).

One is left wondering whether there is scope for such players to collaborate in this field, to pool expertise and to strive for some cost savings.

Planned Timing of Effort

Within the banks that are actively pressing ahead (two-thirds of the sample), the initial planning/preparatory work is already well advanced, and scheduled for completion this year (perhaps spilling over into early 2002).

Banks which are already far advanced in their planning are seeking to take advantage of the extra year to ensure timely completion of these large and complex projects.

Further, they are using the planning phase to define additional business benefits from Basel II spend. Thus the completion of the planning phase would seem to be a key milestone in the project, requiring high level (senior executive and Board) sign-off.

For these banks, the bulk of the detailed implementation work is scheduled to begin almost immediately thereafter (ie early 2002). Most banks indicated a target completion date of end-2003 (to allow for a 12 month cushion to talk things through with regulators), although one bank is currently aiming for an end-2002 completion date.

It seems therefore that the peak workload is over a 12-18 month window, from early 2002 through to 2003.

The timing and scale of effort for the other banks is not clear at this stage, in the absence of a full review of the proposals. It seems the broad approach for this group will be to do the detailed planning once the final proposals are released, then to progress immediately into the implementation phase.

Project Structures

Banks seem to be approaching the project with a two-tier structure: one player categorised it as 'first a thinking and then a doing phase'.

The effort during the current planning/preparation phase comprises a small(ish) team, typically led by Group Risk, but involving all key units. The latter is especially important in establishing buy-in and spreading know-how.

Once the planning is complete, it becomes more of an operations/IT project. It will therefore be these groups which will drive it through the implementation phase, albeit under the ultimate guidance of group risk.

We believe that banks regard the disclosure requirements (Pillar Three) as a separate sub-project, driven in the main by finance.

Resourcing the Project

We noted a difference in banks' confidence that they will be able to meet resource requirements over the lifetime of the Basel II project.

The larger banks believe they have sufficient know-how and quantity of available bodies to meet the demands of the project, and feel confident they will be able to attract/retain additional resources to meet any shortfall.

Smaller banks are already worried about the quantity and mix of available resource. The lack of sufficient modelling/quant skills was most often mentioned.

Planned Use of Consultants

We noted the following attitudes towards retaining external consultants to assist in the planning and delivery of the Basel II project.

Some (typically larger) banks are not planning to use consultants at all.

Other banks (both large and small) are planning on using consultants to meet specific requirements, both for know-how and for additional short-term resources.

The use of consultants as a means of achieving internal consensus was mentioned by several players where buy-in was an issue (see section on Main Challenges below).

Only a small number of institutions are looking to appoint a firm of consultants to work with the institution for the duration of the Basel II projects.

Main Challenges

Data Management

In all cases, banks regard the data gathering and management as a big undertaking, maybe the single largest element of work in the Basel II work. The biggest issues would seem to be:

- the rigorous capture of loss given default information (especially with the implementation of a standardised definition of default);
- the capturing of information about collateral (not such an issue with repos) and other credit-risk mitigation techniques;
- imposing a uniform discipline on the data capture processes once live;
- establishing a meaningful database to underpin a capital charge for operational risk.

Banks are very conscious of the need to start building up a track record and foresee difficulties in meeting the letter of the proposals as currently established. Most survey participants are intending to start this work as soon as is practicable, although this is unlikely to be before 2002.

Buy In

Most interestingly, a common theme is the difficulty of establishing buy-in for this large compliance project, from both senior executives and business heads. The onus for achieving such buy-in has been given to project managers, who have adopted one of the following general approaches.

- Restating the project objectives in terms of delivering substantial business benefits and almost ensuring that the needs of Basel compliance are met (applies to 25% of cases). The challenge in the current planning phase is to define such desirable business objectives: these seem to centre on overhauling measures of business performance, such as refining the process for allocating and charging for capital, the introduction of a more sophisticated RAPM, etc
- Adopting a decentralised model whereby responsibility for planning and implementing the necessary changes are devolved to the business units. The idea here is, notwithstanding the risk that the business units may not devote sufficient time/effort, the end product will be more useful to the business and thereby have their support.
- A more cynical bank mentioned that there seems limited benefit to them; rather, their view was that Basel II was no more than an increase in the cost of being in the game. Their approach therefore is to achieve an adequate level of compliance at minimum cost.

Coping with Delays and Uncertainties

As noted above, the market seems to have polarised into two distinct camps.

In general, the larger and/or more sophisticated players are pressing on at full speed with their Basel II preparations, largely regarding the one-year postponement from 2004 to 2005 as no more

than a recognition of a more realistic timetable for implementation. Given CP3, the detailed plans will need to incorporate flexibility to accommodate changes in the final proposals.

By contrast, the smaller and/or less sophisticated houses are deferring any serious consideration of Basel II before the publication of the revised consultation papers (CP3)

Cultural

Alongside buy-in, a (relatively small) number of institutions highlighted the challenge posed by the necessary cultural and organisational changes that will be required to bring Basel II centre-stage in the way the organisation is managed going forward. Such institutions highlighted previous difficulties in establishing an economic capital regime that was universally accepted internally, and the cultural impediments to adopting a risk-adjusted performance measurement (such as RAROC) as the primary performance measure.

Other Management Priorities

Obviously Basel II is not the sole issue facing financial institutions; in some cases, it is far from being a pressing item, given other priorities. In this vein, 25% of institutions cited gaining sufficient management time as presenting a major challenge to establishing the project.

Costs/Benefits of Basel II

Very few banks have established a budget for the whole Basel II project as yet; this tends to be seen as an output of the more detailed planning phase. Current spend is being managed on a short term (up to end 2001) or even ad hoc basis.

Further, few banks have yet done any serious thinking on the overall costs/benefits arising from the project. Such an equation would include the following elements:

a) The on-going cost of regulatory compliance compared with the status quo ante: it is interesting to note that larger banks tended to foresee a lower future cost (predicated on a convergence of economic and regulatory capital enabling banks to run the two outputs from one common process), whilst smaller banks tended to see much higher compliance costs.

b) Changes in the level of regulatory capital held: as is noted later in the report, roughly half the banks in the survey foresee a reduction in the amount of capital they will be required to hold, whereas half the banks predict an increase.

c) Other benefits and by-products of compliance effort: some banks are deliberately targeting the attainment of wider business benefits out of the Basel II compliance effort. These typically include the following objectives:

- Better/more appropriate (risk sensitive) product pricing
- Improved RAPM
- Improved capital management/allocation
- Moving portfolio management centre-stage.

All in, no banks surveyed had as yet established the net cost/benefit of the project, although several were working on it. We believe that all banks should do this, to ensure that maximum payback is targeted from the project spend.

PILLAR ONE – CREDIT RISK

Chosen (Likely) Approach to Compliance

Not surprisingly, pending completion of the planning phase and the release of CP3, the decision as to which approach to take has yet to be made formally. However, most banks already have a clear game plan as to which approach they will adopt. As of now, banks indicated that they are aiming to adopt the following approach:

Advanced IRB	55%
Foundation IRB	28%
Standardised Approach	9%
Undecided	8%

Drilling down, all the bigger and/or more sophisticated banks are aiming to implement the Advanced IRB approach. It is interesting to note that - even for these players - an issue with the current proposals is the stipulation that each unit (on both a product and geographic basis) will be required to follow this approach or be able to do so following an “aggressive” roll-out.

Interestingly, we noted a (small) number of smaller/less sophisticated players who are also planning to adopt the Advanced IRB approach. Most other players seem to be aiming for the Foundation IRB.

Only one bank admitted that the reason for its decision to go down this route is solely because, on a strict interpretation of the requirements, they would not have built up the requisite track record by 2005 for the Advanced IRB approach, which is what they eventually aim to adopt. Alongside those institutions choosing the Standardised Approach, some hinted that they would consider going down this route, if the Foundation IRB is not materially re-calibrated in a favourable manner in CP3

Impact on Internal Modelling

Most firms surveyed use credit risk models that are at different stages of evolution. For example the retail model might be further advanced than the corporate one (or vice versa). As might be expected (and would certainly be welcomed by the regulators), Basel II is acting as a catalyst for a fundamental review and overhaul of existing credit risk models. This overhaul is likely to be achieved by a mixture of in-house development and the purchase (and customisation) of external models, although few banks seem to have decided the optimum solution yet.

Establishing Track Record and Data Challenges

In all cases, banks regard the data gathering and management as a big undertaking; maybe the single largest element of work in the Basel II work. To quote one program manager, “We are conceptually up the curve; implementation is the biggest issue.”

The biggest issues would seem to be:

- the rigorous capture of loss given default information (especially with the implementation of a standardised definition of default);
- the capturing and treatment of collateral information (with the exception of repos) and other credit mitigation techniques;
- imposing a uniform discipline on the data capture processes once live.

Banks are very conscious of the need to start building up a track record and do foresee difficulties in meeting the letter of the proposals as currently established. Most survey participants are intending to start this work as soon as is practicable, although this is unlikely to be before 2002.

THE DATA MANAGEMENT CHALLENGE:

Banks seeking to move to the Internal Ratings Based (IRB) Approach will need to ensure that their credit risk management processes meet the following requirements:

- There must be sufficient granularity, in terms of the number of individual rating grades, each of which need to be mapped to a default probability, in a consistent manner, for all credit businesses, on both a business line and geographic basis;
- It must backtest its ratings process, in order to validate the predictive powers of its internal ratings;
- The bank will need to demonstrate that the ratings process is core to both their CRM processes and their internal capital allocation process;
- The whole rating, mapping, and backtesting process needs to be transparent enough, such that it can be reviewed by 3rd party (ie regulators).

However, this raises several data management challenges that must be overcome as part of the implementation:

- **Moving to Standardised Definitions and Parameters:** Basel II stipulates key inputs into the model - such as stipulating a minimum number of grades used within the internal ratings process, the time horizon for the model (one year) and a standard definition of default.
- **Group-wide coverage:** Many banks, even those that currently operate sophisticated internal ratings systems, will find they are elements of their book that are either unrated, or where a much less rigorous approach was applied. Banks need to ensure they have complete and consistently applied internal ratings coverage of their whole credit portfolio.
- **LGD:** Getting robust information on LGD is one of most intractable problems that many banks face in improving their credit risk management calculations. Issues include making allowance for the whole range (and modeling the value) of collateral and covenants; factoring the additional costs of default (admin, legal, plus funding costs) into LGD; allowance needs to be made for restructurings (debt-for-equity swaps, etc); different groups within bank(s) responsible for debt work-out, making collating the overall history more complex.
- **Track-record and Backtesting:** Banks will need to retain enough data to validate internal ratings systems, and, in particular, the default probabilities they assign to each rating. This implies having the capability to retain information on all rating decisions: who took them, which model was used, what data was used, etc, for all borrowers. All this must be capable of being reviewed by the regulators.

Reflections on Qualitative Standards

In general, banks did not see the qualitative requirements as presenting much/any challenge. One bank though did have doubts as to whether their CRM function would be deemed 'independent' enough for Basel II purposes.

Other

No mention was made as part of the Basel project of re-engineering the credit function (*ie* a move from an "originate and hold" model to a split between origination and portfolio management). A move to a more risk-sensitive approach would logically lead in that direction.

OBJECTIVES OF BASEL II WORK:

CREDIT RISK

It is likely that work in the credit area will be the single biggest element of most Basel II projects. Whilst most banks already have relatively sophisticated credit risk models, the demands of Basel II are leading them to upgrade data capture (especially with regard LGD and credit risk mitigation data) and modelling.

As high-level rationale for all this effort, we believe that it is important that banks have as their primary focus the delivery of a best practice business model in this area, which may necessitate two fundamental improvements:

- feeding the insight gained from a truer understanding of risk contributions into more risk-sensitive loan pricing and performance measurement;
- restructuring the lending business model from one of 'originate and hold' to one where the decision as to which loan assets are to be retained is driven by a central portfolio management unit independent of the origination function.

Both are complex to achieve, technically and culturally. The technical side relies critically on more accurate models for allocating and pricing capital, which in turn are driven by sophisticated models of default and correlation. Banks' culture is a trickier issue to generalise on, but will ultimately be the deciding point in determining the winners and losers going forward.

Given the tremendous over-capacity in the lending markets and the uneven playing field introduced by having different capital adequacy approaches, we believe that the only way a bank can compete post-2005 and seek to ensure it is truly adding shareholder value from its lending businesses is by adopting the business model outlined above.

PILLAR ONE – OPERATIONAL RISK

Chosen (Likely) Approach to Compliance

The overall feedback we received on operational risk is that there are serious deficiencies with the extant proposals: indeed, there were some dismissive comments on the whole thrust here. Given what is perceived as a less developed framework, it is not surprising to note that fewer banks have made even indicative choices as to which approach to adopt, pending CP3.

IMA	35%
Standardised Approach	20%
Undecided	45%

Impact on Internal Modelling

As might be expected, this is an area where almost all banks are self-confessedly behind the curve, although all banks reported having embarked on some data collection and risk modelling projects (often over the 12/18 months). Our impression was that this had tended to focus on high frequency/low impact events to date. However, whilst there is acknowledgement that banks should make improvements in this area, there would seem to be scepticism about whether there are any real business benefits from going down the route that the January 2001 proposals paper lays out. This applies as much to the deemed artificiality of splitting operational from other (mainly market/credit) risk, as it does to concern that there is in reality insufficient data on which to build a truly quantitative approach.

Establishing Track Record and Data Challenges

Given the lack of clarity and detail in CP2 on operational risk, it is not surprising that few banks have yet focused on the exact workload in this field. It would seem obvious that this will involve integrating both internal and external (eg BBA) data.

Reflections on Qualitative Standards

Likewise, banks have seemingly given little thought to the qualitative standards as yet, although we noted that almost all banks had now set up an independent operational risk unit, usually as a subset of group risk management.

Other

The way forward here is none too clear. We get the impression that banks may well do the minimum required to meet the regulators' final demands.

OBJECTIVES OF BASEL II WORK:

OPERATIONAL RISK

It seems to us that there are two distinct areas within operational risk. The first is the everyday high frequency but low impact events that are part of normal business, such as credit card fraud. The other is the very rare but life-threatening events, such as the rogue trader syndrome at Barings.

All banks have already set up teams to collate and model the appropriate internal data of high frequency/low impact events: indeed, many institutions are already quite advanced in this area.

We believe that this is a useful process. However, where we differ from the BCBS is that we believe the output of such models should not be used in terms of determining capital requirements, but should instead be used to set up appropriate (expected loss) provisions.

The more critical area from a capital adequacy perspective is the life-threatening low-frequency high-impact events. It is now commonly held that existing banks almost by definition do not have sufficient internal data for such events to act as a feed into statistical models (indeed, it is highly unlikely that any bank that did have sufficient data of this nature would still be in existence today). This has led to the creation of several industry-wide databases, such as the ones being collated by the BBA, NetRisk, etc.

We are worried as to whether there is much serious mileage to be gained from going down this route. After all, a lot of work (from a data and a modelling perspective) was pioneered by Bankers Trust, a firm whose swift demise - despite its sophistication in this sphere - was ultimately triggered by what would be now be classified as operational risk events.

The attempt to model this area of risk seems to miss the key point that life-threatening operational risk events are likely to arise from one or more of the following:

- poor senior management/Board understanding of the true nature and risk profile of one of its business;
- too much weight and authority being given to powerful individuals, without sufficient independent or peer scrutiny being exercised (this usually occurs as a corollary of the preceding point);
- inadequate or inappropriate operating environments, in terms of the adequacy of people and support (usually IT) systems;
- cultures that are driven solely by bottom line contribution, rather than ones that use a risk-based performance measure.

In our opinion, rather than spending time and effort on a Pillar 1 capital charge, banks should be asked to come up with a detailed self-assessment on the above criteria, signed off by the audit committee. This would then be fed into the regulators, as part of their Pillar 2 review. Banks with a poor operating environment would then be subject to higher capital ratios, an event that it would be forced to disclose under Pillar 3.

PILLAR TWO – STRATEGIC CAPITAL MANAGEMENT

Net Impact of Basel II on Capital Adequacy

Most banks have done some preliminary estimates of the likely impact of Basel II on their capital adequacy requirements. This work will be subject to refinement in the light of CP3. Based on this initial work, banks provided the following estimates of the impact of Basel II on the level of regulatory capital they will be required to hold

Will lead to an increase	45%
Will lead to a decrease	45%
Not sure	10%

Prima facie this would be the result that the regulators are aiming for, given their commitment to broadly maintain the overall level of capital in the system. However, it should be noted that these figures do not give indication of the estimated size of change (where the expected increases seem larger than expected decreases). Indeed, one (small) institution was at pains to point out their concerns that, to accommodate a small decrease in the capital required for large banks, a proportionately large increase would need to be levied on smaller institutions.

The main drivers of change (where specified) are the increase due to the introduction of a charge for operational risk, and either small decreases or large increases dependant on the credit book.

Links with Economic Capital

Strategic capital planning is due to be specifically reviewed by the regulators under Pillar Two. Meeting this requirement was only deemed to be a challenge by a couple of small institutions, who both cited lack of know-how/resource as the issue.

We looked more broadly at the number of banks who currently run an economic capital model, the breakdown being:

Have a model	55%
Working on implementation now	10%
No plans currently	35%

We were interested to note that a number of banks currently running an economic capital model (50% of this population) see Basel II as leading materially to a convergence of economic capital and regulatory capital models, which they see as a major plus from an operational perspective. They do though see the need to make some minor tweaks, especially concerning the treatment of 'expected loss' provisions, but overall tend to see Basel II as a step on a process that will lead to full internal modelling.

The most sophisticated players will tend to keep their economic capital model going as a separate process.

Less sophisticated players who do not have economic capital models currently use regulator capital as the denominator for internal capital allocation and performance measurement purposes. It is likely that they will substitute Basel II as the denominator, and accordingly implement Basel II as a proxy economic capital model.

Impact on RAPM

The amount of capital allocated to business lines and products will obviously change as a result of Basel II, with the knock-on effect of product pricing. Our impression was that such changes in the risk denominator seemed at times to be the cause of tension between different business units.

Overall though, this area of more accurate pricing and performance measurement seems to be of great interest to business management, and implementation of more sophisticated techniques will - along with improvements to credit portfolio management - be one of major pluses targeted by many Basel II programs. This is especially the case in institutions where buy-in to the costs/scale of a purely regulatory reporting program lacks sufficient buy-in.

Dealing with Volatility of Capital Requirements

Few banks seem to have done much thinking as yet on the impact on business management of moving to a more risk sensitive capital regime. This tended to be an area for consideration further down the line (late 2002?).

One bank we spoke to seemed to have completed its thinking here, based on which it is worried about the future price of capital. Accordingly, it has already explicitly sought to raise additional capital, as a cushion against a likely increase in the size and cost of its capital base.

LEARNING TO LIVE WITH CAPITAL VOLATILITY

A major issue inherent in the more risk sensitive approach to capital adequacy is that of volatility of capital levels. One Swedish bank has seemingly done some modelling that shows that the level of regulatory capital on the same book of business would double over the economic cycle.

Banks that are not used to this environment from running economic capital models will have to learn how to cope with this volatility in their capital planning process. We believe that this should include taking advantage of the following techniques:

- adopting a more sophisticated approach to planning future levels of capital requirements, such as the use of a real options framework;
- making more extensive use of contingent capital instruments, including embedding credit risk derivatives in debt instruments such that the stock of available capital fluctuates in line with changes in the riskiness of the bank's loan books.

PILLAR THREE – DISCLOSURE REQUIREMENTS

Most banks acknowledge that the disclosure requirements are theoretically straightforward.

However, in practice, the feedback is that meeting the requirements - at least, as currently framed - would be a logistical nightmare, both in terms of beefing up the reporting and accounting systems to churn out the required data and operationally once live in terms of the on-going production and verification of the output.

Most banks will seemingly have to upgrade the requisite systems, most likely probably in 2003, driven by finance. Others area affected will by risk management and corporate communications.

OTHER ASPECTS OF BASEL II

Training and Education

All banks acknowledge the need to get a wide group of people up the curve with the implications of Basel II. Initially, this has tended to be by way of feeding information into business heads and executive committees. Down the track, it is broadly recognised that a wider group of people will have to be brought up the curve, varying from finance to business lenders and operations staff. This will often be done with some external assistance.

Dealing with the Regulators

Several survey participants mentioned the importance of establishing meaningful dialogue with the regulators as part of their Basel II efforts. This seemed to be at several levels: initially, the aim seems to be establishing clarity on interpretation on several areas of uncertainty in the proposals.

The main dialogue that banks are preparing would seem to be in 2004, when they expect to inform the regulators on their detailed preparations, which will then be subject to vetting by them.

Worryingly, especially given the regulators' perspectives, is the unsolicited concern expressed by several survey participants as to the ability of the regulators to discharge their responsibilities under Basel II, especially with regards the detailed review of models.