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**REGULATORY CHANGES RELATING TO MARKET AND OPERATIONAL RISK
ASSESSMENT – INTERNATIONAL – BASLE II**

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Basel II Global Implementation & Response

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Audit. Tax. Consulting. Financial Advisory.

Agenda

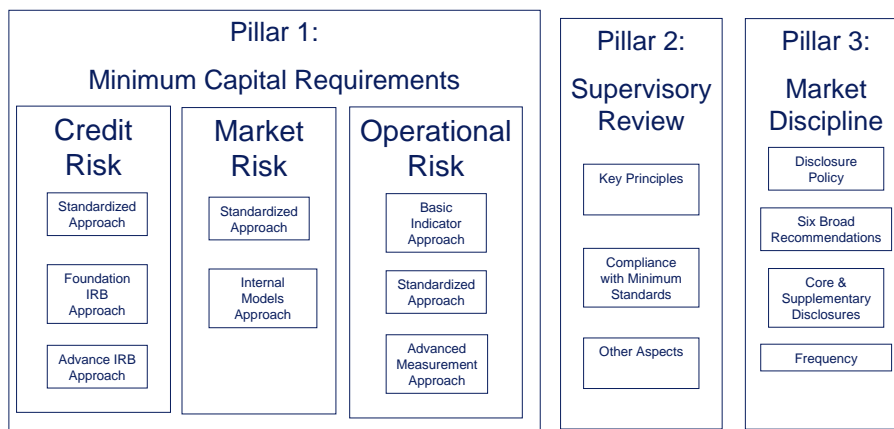
1. Basel II Overview and Refresher
2. Review of VaR
3. Top Global Implementation Issues
4. Using VaR to Drive Value and Implementation – Lessons Learned from Basel II
 - Deciding where to focus
 - Operational Considerations
 - Responding to Regulatory Change, two approaches to Basel II
5. Conclusion

Objectives of the Basel II Capital Accord

Basel II is not ultimately about capital. It is about strong, effective risk management

- Provide capital incentives to those banks with advanced risk management practices
- Constitute a more comprehensive approach to addressing risks
- Promote safety and soundness in the financial system – and at least maintain the current overall level of capital in the banking system
- Develop approaches to capital adequacy that are appropriately sensitive to the degree of risk involved in a bank's position and activities; and
- Ensure principles are suitable for application to banks of varying levels of complexity and sophistication
- Enhance competitive equality

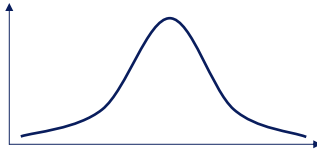
The Basel II Capital Accord



These pillars are mutually reinforcing, working together to contribute to a higher level of safety and soundness in the financial system.

Value at Risk

- Is the loss, or change in value that is not expected to be exceeded with a given degree of confidence over a specified holding period
 - Generally the holding period should correspond with the period required to liquidate the portfolio
 - VaR can be calculated using either a one tailed or two tailed approach.



- A one tailed approach calculates the maximum loss
 - A two tailed approach calculates both the maximum loss and gain
- E.g. assuming a 98% confidence level, a five day holding period and a one tailed approach then a VaR of \$1,000,000 would indicate that there is a 2% probability that any loss over the next five days will exceed \$1,000,000
- A two tailed approach would indicate that there is a 1% chance that any loss *or* gain will exceed \$1,000,000 over the next five days

Value at Risk – Select Basel Committee Requirements

Qualitative

- Active Board and senior management involvement in market risk management activities
- Independent risk function responsible for the design and implementation of the market risk system
- Measurement models, processes and systems are closely integrated in day-to-day management
- Regular, periodic validation of the effectiveness of the system, including backtesting
- Independent review of the risk management system

Quantitative

- Calculated daily, one tailed and using 99% confidence level
- Minimum 10 day holding period
- Minimum of 1 year of observed historical data, updated a minimum of every three months

Value at Risk - Benefits

- Provides a method for quantifying the risk of financial instruments
- Measures risk across assets, markets, duration etc. while also incorporating hedge effectiveness and portfolio effects
 - Provides a common language
- Designed to predict the future value of the portfolio, not future realized losses
- May be used as a tool to track changes in the portfolio, if monitored and tracked over time

Basel II Implementation – Top Issues

Use & Validation

- How do you fully integrate the new and/or enhanced, risk management processes and methodologies into the business?
- What role will the businesses, monitoring functions, and internal audit play in the validation process?
- What will regulators ask for to demonstrate compliance with the more qualitative aspects of the use test?

Compliance Focus

- Increasing costs, and the diminishing prospects of meaningful capital relief are causing institutions to shift resources from potential business benefits to strictly compliance activities

Integration with CEO/CFO Certification

- Substantial potential benefits seen by integrating aspects of CEO/CFO certification programs with Basel II
- Focus on entity level governance and technology execution

Basel II Implementation – Top Issues

Technology

- Many institutions drastically underestimated the level of effort required to identify, capture and store the required data
- Significant delays were often caused by overestimating the quantity, quality and availability of existing data

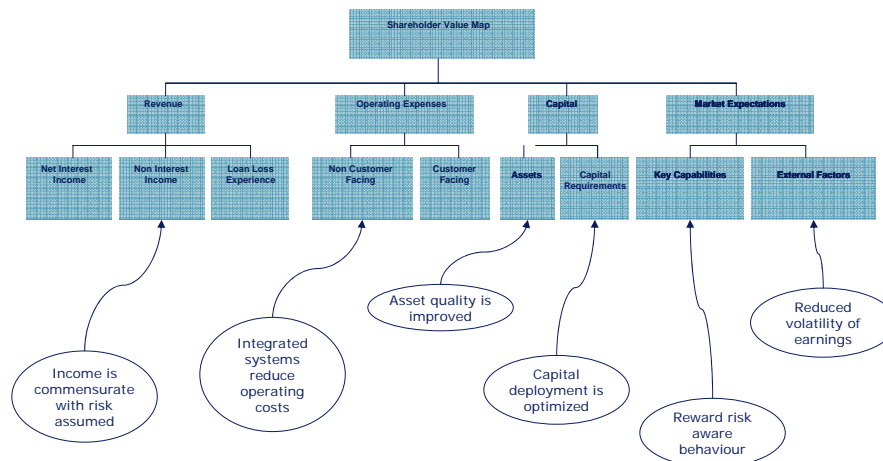
Capabilities

- The availability of scarce human resources – particularly experienced, qualified quantitative specialists are key to success

Capital Implications

- HSBC claims that Basel II is unlikely to result in group-wide capital savings (HSBC have 1,000 people involved in Basel II preparations globally)
- Select Regulators have stated that they expect implementation of the Accord to be capital neutral across the system

Basel II & VaR Where is Value Created?



Basel II & VaR Operational Considerations

- Consider how adoption will impact business operations
 - Governance
 - Expanded Board responsibilities, individual accountability and focus on governance functions
 - Risk Management
 - New measurements, tools, & reporting
 - Potential realignment of the risk management function
 - Trading Desk & Front Office
 - Risk adjusted return
 - Finance
 - Determining the role of finance vs. risk management
 - Establishing a strategy for disclosure and ensuring the investments in risk management impact the firm's valuation
 - Technology
 - Complex systems to design (modify), build, implement and maintain
 - New data accuracy standards
 - Operations & Back Office
 - Data collection

Basel II Two Approaches to Implementation

United States vs. Germany

- Similar banking structure - three tiers
 - A few large money centre banks, larger number of regional players and a very large pool of relatively small local banks

Germany

- All banks eligible to adopt Basel II
- Smaller banks faced financial and resource constraints to implementation
- Smaller, local banks intending to implement the advanced approaches are pooling their resources through industry umbrella groups, allowing them the possibility of achieving AIRB, and AMA compliance

United States

- Only the top 20 Banks eligible
- Smaller banks adopting a wait and see approach
- Augmenting their qualitative risk management capabilities

Questions

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